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THE PROVISION OF BENEFITS BY THIRD PARTIES: FRINGE BENEFIT TAX (FBT) CONSEQUENCES – SECTION CI 2(1)

PUBLIC RULING – BR PUB 04/05

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

Taxation Laws

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

This Ruling applies in respect of section CI 2(1) and the definition of "arrangement" in section OB 1.

The Arrangement to which this Ruling applies

The Arrangement is the receipt of a benefit by an employee from a third party where there is an arrangement between the employer and the third party and where the benefit would be subject to FBT if it had been provided by the employer.

The Arrangement does not include situations where the remuneration given by an employer to an employee is reduced due to a benefit being received from the third party, or otherwise takes the receipt of a benefit provided by a third party into account (including salary sacrifice situations). There cannot be any trade-off between the benefits provided and the remuneration that would otherwise have been received by the employee, or any difference between the remuneration levels of employees who receive benefits and those who do not.

How the Taxation Laws apply to the Arrangement

The Taxation Laws apply to the Arrangement as follows:

- For the purposes of section CI 2(1), there will be an arrangement for the provision of a benefit to employees where:

  (a) consideration passes from the employer to the third party in respect of the benefit being provided; or

  (b) the employer requests (other than merely initiating contact), instructs, or directs the third party to provide a benefit; or

  (c) there is negotiation or discussion between the employer and the third party which (explicitly or implicitly) involves the threat or suggestion that the employer would withhold business or other benefits from the third party unless a benefit is provided to the employees; or

  (d) the third party and the employer are associated parties, and there is a group policy (whether formal or informal), or any other agreement between the associated parties, that employees of the group will be entitled to receive benefits from the other companies in the group.

- Provided that none of the above exists, there will not be an arrangement for the provision of a benefit to employees for the purposes of section CI 2(1) where:

  (a) there is negotiation or discussion between the employer and the third party that results in no more than:

    (i) the employer granting the third party access to the premises or work environment to discuss the benefit with employees; and/or

    (ii) agreement between the parties as to the level of benefit that is to be offered by the third party to employees; and/or

    (iii) the employer agreeing to advertise or make known the availability of the benefit; or

(b) the employer has done no more than initiate contact or discussions with the third party; or

(c) there is no significant contact between the employer and the third party.

The period for which this Ruling applies

This Ruling will apply for the period from 20 May 2004 until 19 May 2007

This Ruling is signed by me on the 20th day of May 2004.

Martin Smith
General Manager (Adjudication & Rulings)

COMMENTARY ON PUBLIC RULING BR PUB 04/05

This commentary is not a legally binding statement, but is intended to provide assistance in understanding and applying the conclusions reached in Public Ruling BR Pub 04/05 ("the Ruling").

This Ruling relates to an issue arising in the context of fringe benefit tax, and has been under preparation for some time. Fringe benefit tax is currently the subject of a government review. It is not known whether section CI 2(1), as presently enacted, will be amended as a result of this review. The Commissioner has decided to issue this Ruling at this time, notwithstanding the current review of FBT, as he considers that it is still likely to be of assistance to taxpayers in any event. It is likely to be some time before any resulting legislation is enacted. The Commissioner notes that if section CI 2(1), or the law in relation to the provision of benefits by third parties, is amended as a result of this review or otherwise, this Ruling may cease to apply from the date that legislation is effective.

Background

This Ruling arises from a number of private ruling applications that the Rulings Unit has considered. It considers the scope of section CI 2(1), and what will be an "arrangement" that falls within the scope of the section.

Legislation

Section CI 2(1) states:

> For the purposes of the FBT rules, where a benefit is provided for or granted to an employee by a person with whom the employer of the employee has entered into an arrangement for that benefit to be so provided or granted, that benefit shall be deemed to be a benefit provided for or granted to the employee by the employer of the employee.
>
> "Arrangement" is defined in section OB 1 to mean, unless the context otherwise requires:
>
> …any contract, agreement, plan, or understanding (whether enforceable or unenforceable), including all steps and transactions by which it is carried into effect:

Application of the Legislation

Liability for FBT

Under section CI 1, an employer is liable to pay FBT on fringe benefits provided or granted to an employee by the employer. However, under section CI 2(1) an employer can be liable for FBT if the employer enters into an arrangement with another person (the "third party") for the provision of fringe benefits to the employer's employees.

Section CI 2(1) is an anti-avoidance provision. For it to have any application there must be **an arrangement** between the employer and the third party (the provider of the benefit), and that arrangement must provide for or grant a benefit to the employee of the employer entering into the arrangement.

It is clear that section CI 2(1) applies where any form of consideration passes from the employer to the third party to compensate for, or is otherwise in relation to, the benefit provided by the third party to the employee. The wording of section CI 2(1) is very broad and seems to apply in a range of cases wider than this obvious one.

The issue is: where there is no direct or indirect consideration (in any form) provided by the employer to the third party, in what circumstances will the provision apply?

Conclusion on the application of the section

It is concluded that section CI 2(1) will apply, as there will be an arrangement for the provision of a benefit, in each of the following situations:

- Where consideration passes from the employer to the third party in respect of the benefit being provided; or
- Where the employer requests (other than merely initiating contact), instructs, or directs the third party to provide a benefit; or
- Where there is negotiation or discussion between the employer and the third party which (explicitly or implicitly) involves the threat or suggestion that the employer would withhold business or other benefits from the third party unless a benefit is provided to the employees; or
- Where the third party and the employer are associated parties, and there is a group policy (whether formal or informal), or any other agreement between the associated parties, that employees of the group will be entitled to receive benefits from the other companies in the group.

Provided that none of the above situations exist, it is concluded that there will not be an arrangement for the provision of a benefit, and section CI 2(1) will not apply, in the following situations:

- Where there is negotiation or discussion between the employer and the third party that results in no more than:
  - (i) the employer granting the third party access to the premises or work environment to discuss the benefit with employees; and/or
  - (ii) agreement between the parties as to the level of benefit that is to be offered by the third party to employees; and/or
  - (iii) the employer agreeing to advertise or make known the availability of the benefit; or
- Where the employer has done no more than initiate contact or discussions with the third party; or
- Where there is no significant contact between the employer and the third party.

What is meant by the term "arrangement"?

The definition of "arrangement" in section OB 1 makes it clear that the term "arrangement" is very wide in its application, and that it encompasses not only legally binding contracts, but also even unenforceable understandings. It is clear that what is required for an arrangement to exist is less than that required for a binding contract.

The Concise Oxford English Dictionary (10th Edition, 1999) defines the individual words referred to in the section OB 1 definition as follows:

- "contract" – a written or spoken agreement intended to be enforceable by law
- "agreement" – a negotiated and typically legally binding arrangement
- "plan" – a detailed proposal for doing or achieving something
- "understanding" – an informal or unspoken agreement or arrangement.

The above definitions show that the words used to describe an "arrangement" in section OB 1 form a sequence that descends in formality from a legally enforceable contract to a mere informal, unenforceable "understanding". These words all appear to be slightly differing concepts, each one less strict than the previous term.

The meaning of "arrangement" has been considered by the courts in a number of cases, and generally the cases have found that the term "arrangement" applies in a wide range of situations.

The High Court of Australia in *Bell v Federal Commissioner of Taxation* 87 CLR 548, (1953) 10 ATD 164 considered the meaning of "arrangement" and, at page 573, stated:

> …it may be said that the word "arrangement" is the third in a series which as regards comprehensiveness is an ascending series, and that the word extends beyond contracts and agreements so as to embrace all kinds of concerted action by which persons may arrange their affairs for a particular purpose or so as to produce a particular effect.

The Privy Council in *Newton and others v Commissioner of Taxation of the Commonwealth of Australia* [1958] 2 All ER 759 held (at page 763):

> Their Lordships are of opinion that the word "arrangement" is apt to describe something less than a binding contract or agreement, something in the nature of an understanding between two or more persons – a plan arranged between them which may not be enforceable at law. But it must in this section comprehend, not only the initial plan but also all the transactions by which it is carried into effect – all the transactions, that is, which have the effect of avoiding taxation, be they conveyances, transfers or anything else.

This passage was quoted and applied by Eichelbaum J in the High Court decision in *Hadlee and Sydney Bridge Nominees Ltd v CIR* (1989) 11 NZTC 6,155. The Court of Appeal subsequently approved this.

The Court of Appeal considered the meaning of the term "arrangement" in *CIR v BNZ Investments* (2001) 20 NZTC 17,103. The majority judgment of Richardson P and Keith and Tipping JJ was delivered by Richardson P. He stated, at page 17,116:

> [43]…As did the former s108, s99 bites on an "arrangement made or entered into". It presupposes there are two or more participants who enter into a contract or agreement or plan or understanding. They arrive at an understanding. They reach a consensus.
>
> …
>
> [50]…In short, an arrangement involves a consensus, a meeting of minds between parties involving an expectation on the part of each that the other will act in a particular way. …The essential thread is mutuality as to content. The meeting of minds embodies an expectation as to future conduct. There is consensus as to what is to be done.

A number of other cases in the area of income tax avoidance are consistent with the comments made in the above case law.

Besides income tax cases, some other case authorities on the meaning of "arrangement" in other statutory contexts are considered relevant by the Commissioner.

The Court of Appeal in *Re British Basic Slag Ltd's Agreements* [1963] 2 All ER 807, stated, at page 814:

> Though it may not be easy to put it into words, everybody knows what is meant by an arrangement between two or more parties. If the arrangement is intended to be enforceable by legal proceedings, as in the case where it is made for good consideration, it may no doubt properly be described as an agreement. But the statute clearly contemplates that there may be arrangements which are not enforceable by legal proceedings, but which create only moral obligations or obligations binding in honour...For when each of two or more parties intentionally arouses in the others an expectation that he will act in a certain way, it seems to me that he incurs at least a moral obligation to do so. An arrangement as so defined is therefore something "whereby the parties to it accept mutual rights and obligations".

In *Trade Practices Commission v Email Ltd* (1980) 31 ALR 53, the Federal Court of Australia considered whether it was sufficient for an "arrangement" or "understanding" that only one party is under an inhibition in respect of his or her future conduct. The Court stated (at page 66):

> Unless there is reciprocity of commitment I do not readily see why the parties would come to an arrangement or understanding. Particularly is this so when it is remembered that the alleged parties to the agreement or understanding in the present case are two large companies. Presumably if they were to reach an understanding or arrangement each would have some commercial objective beneficial to itself in mind. I see no point in an arrangement bare of reciprocity.
>
> Although there is much force in the submissions on behalf of the respondents that it is difficult to imagine a practical example in trade or commerce of a party to an arrangement being subjected to a burden qua the other and that other being under no obligation himself, I incline to the view that there is no necessity for an element of mutual commitment between the parties to an arrangement or understanding such that each accepts an obligation qua the other; although in practice such cases would be rare.

The Privy Council in *New Zealand Apple and Pear Marketing Board v Apple Fields Ltd* [1991] 1 NZLR 257 stated, at page 261:

> "Arrangement" is a perfectly ordinary English word and in the context of section 27 [of the Commerce Act 1986] involves no more than a meeting of minds between two or more persons, not amounting to a formal contract, but leading to an agreed course of action.

To summarise, the following principles or characteristics can be extracted from these cases on the meaning of "arrangement" in other statutory contexts than income tax to indicate when an "arrangement" exists:

- A meeting of minds on an agreed course of action for a particular purpose (see *New Zealand Apple and Pear Marketing Board v Apple Fields)*.
- The parties to agree to mutual rights and obligations in respect of the course of action to be undertaken (see *Re British Basic Slag Ltd's Agreements*).
- An arrangement is unlikely to exist when only one party makes a commitment to the proposed course of action (see *Trade Practices Commission v Email Ltd*).

An "arrangement" encompasses various degrees of formality, and the case law in the areas of tax avoidance and competition law reinforces this conclusion. In the context of section CI 2(1), the term "arrangement" will include situations where the employer arranges with the third party to provide a benefit, where the employer agrees to allow the third party to approach the employees, or where the employer agrees to allow an employee to join a scheme promoted by the third party.

In terms of the application to section CI 2(1), for there to be an "arrangement" which is caught under the section, it must be an arrangement "for" a benefit to be "provided" to an employee. This means that not every "arrangement" that exists between an employer and a third party will be caught by section CI 2(1). Similarly, not every instance where a benefit is provided to an employee by a person who is not their employer will be caught by the section.

However, the arrangements that will be subject to FBT under section CI 2(1) will be limited by the requirement that it must also be "for" the provision of a "benefit" to an employee.

What is the meaning of "for" as used in the section?

The word "for" can have a wide variety of meanings depending on its context. The Court of Appeal in *Wilson & Horton v CIR* (1995) 17 NZTC 12,325 stated (at page 12,330):

> Reference to any standard dictionary brings home the wide variety of senses in which the preposition "for" may be employed. The *Oxford English Dictionary* (2nd ed) identifies 11 separate categories of meaning and many distinct usages within particular categories. The discussion in the text extends over 9 columns in the dictionary. Again the *Tasman Dictionary* which as its name suggests is directed to Australian English and New Zealand English, lists 33 meanings of the word. **The particular meaning intended necessarily hinges on the context in which the word is used and how it is used in that context**.
>
> (Emphasis added)

The use of the word "for" was interpreted in the case of *Patrick Harrison & Co. v AG for Manitoba* [1967] SCR 274 as imposing a purpose test. In this case, the Court held that "for the extraction of minerals" meant "with the object or purpose of extracting minerals".

In *G v CIR* [1961] NZLR 994, McCarthy J held that the word "for" points to intention, which is similar to looking at a person's purpose. At page 999, McCarthy J stated:

> "For" points to intention. …the essential test as to whether a business exists is the intention of the taxpayer as evidenced by his conduct, and that the various tests discussed in the decided cases are merely tests to ascertain the existence of that intention. I think that it conforms with this approach to construe the word "for", when considering a phrase such as "carried on for pecuniary profit" used in relation to an occupation, as importing intention.

These cases show that in a number of statutory contexts the word "for" has been interpreted by the courts to mean "for the purpose" or "with the object of" something. It is noted that in this context, a person's purpose is similar to looking at his or her intention. However, to determine the word's meaning in the current section, it is necessary to look at the section's wording.

Section CI 2(1) states that "…the employer of the employee has entered into an arrangement **for** that benefit to be so provided…". Section CI 2(1) requires there to be an arrangement between the persons for the appropriate benefits to be provided or granted to the employees. The use of the term "for" in this context can only mean that the arrangement entered into is concerned with the provision of these benefits. That is to say that the "arrangement" must have been entered into "for" the provision of a benefit to an employee.

In the Commissioner's opinion, based on the case law and dictionary definitions, the "arrangement" entered into pursuant to section CI 2(1) must be "for the purpose" of providing the appropriate benefit to the employees, or "with the object" of providing the benefit.

Does the section require consideration of the purpose of the "arrangement" or the purpose of a party to the arrangement?

Two possible interpretations of this section result from the conclusion that the word "for" points to purpose. The first is that the section could mean that one, or both, of the parties to the "arrangement" (being the employer and the third party) have the purpose of providing a benefit to the employee. The other interpretation is that the purpose of the "arrangement" that has been entered into is to provide an employee with a benefit. The latter interpretation potentially requires an objective inquiry into the arrangement itself, as opposed to an inquiry as to the purpose of one or more individuals.

The first interpretation above could be considered to be supported by the case law relating to what is now section CD 4, where the word "purpose" has been interpreted by the courts to mean the dominant purpose of the taxpayer (see, for example *CIR v Walker* [1963] NZLR 339).

The second interpretation could be seen as being supported by the interpretation the courts have given to the phrase "tax avoidance arrangement" (as defined in section OB 1) in the context of section BG 1 and earlier corresponding provisions. The courts have held that in this context the test for purpose should be determined by looking at the intended effect of the arrangement (see, for example, *Newton v FC of T* (1958) 11 ATD 442).

In the context of section CI 2(1), it would appear that the better interpretation is to consider the purpose of the **parties** to the "arrangement" to determine if the "arrangement" was entered into for the provision of a benefit.

The section could not logically be considered to be referring to the purpose of the "arrangement". It would appear to be an unusual interpretation of the section to require consideration of the purpose of the "arrangement", as section CI 2(1) does not actually include the word "purpose". Therefore, the purpose of one or both of the parties needs to be looked at when considering whether the "arrangement" was entered into "for" the benefit to be provided.

It may be argued that, as section CI 2(1) is an anti-avoidance provision, the test for purpose should be the same as that used in the general anti-avoidance provision, section BG 1. However, section CI 2(1) does not refer to the arrangement having a particular purpose or effect, as does the section OB 1 definition of "tax avoidance arrangement". That definition refers to "its" purpose or effect, that is, the arrangement's purpose or effect.

Therefore, the word "for" in section CI 2(1) does not refer to the purpose of the "arrangement" itself, but to the purpose of one or both of the parties who have "entered into" the "arrangement".

This conclusion is reinforced by the use of the phrase "entered into" in section CI 2(1). The section requires that the employer and the third party have "entered into an arrangement for that benefit to be provided". This indicates that the reason the "arrangement" was "entered into" by the parties to it must have been "for" the provision of a benefit. In other words, the parties' "purpose" in entering into the "arrangement" must have been to provide a benefit.

Therefore, the relevant purpose to be determined for the purposes of section CI 2(1) is that of one (or both) of the parties to the "arrangement", and not the purpose of the "arrangement" itself.

Whose "purpose" is relevant for section CI 2(1), the employer's, the third party's, or both?

As previously mentioned, for section CI 2(1) to apply there must be an "arrangement" between the employer and a third party. It is therefore necessary to determine whose purpose must be considered when applying the section.

When a benefit has been provided to an employee by a third party under an "arrangement", section CI 2(1) imposes FBT liability on an employer as if the benefit had been provided by the employer. This implies that the "arrangement" between the employer and the third party must be one where it is appropriate for the employer to be liable for FBT. If the employer does not have the purpose of providing a benefit to the employee, then it would seem unfair, and illogical, to impose FBT liability.

Section CI 2(1) is an anti-avoidance provision. The prospective liability to tax is the employer's (FBT), which liability the employer is seeking to avoid. The third party is not seeking to avoid tax liability because it has no prospective liability. At most, a third party would be a knowing assister in the employer's avoidance. More likely perhaps, the third party, whatever the employer's motivations, would be seeking to enter into commercial arm's length dealings with an employer and employees ignorant of, or indifferent to, the employer's tax liability. This suggests that, from a policy perspective, it might be expected that the employer's, not the third party's purpose, would be the more relevant.

Also, it is likely that the third party will always have the requisite purpose of providing a benefit to an employee, whether this is determined objectively or subjectively, as the third party is the party that provides the benefit to the employee. If the purpose of the third party alone were considered, all benefits would appear to be caught under the section: an illogical interpretation of the section.

It could be argued that the use of the words "entered into … for" suggests that both parties must have the purpose of providing a benefit, as both parties must have "entered into" the "arrangement". However, this interpretation would not seem entirely sensible, as the third party will most likely have this purpose, and the result would be no different from considering the employer's purpose alone. Therefore, it is not necessary to consider the purpose of both parties, and the purpose of the employer alone should be considered.

Therefore, the party to the "arrangement" whose purpose should be considered in determining whether section CI 2(1) applies, is the employer.

Should the test to determine whether the employer has "entered into an arrangement for that benefit to be so provided" be objective or subjective?

The above conclusions combine to show that for an "arrangement" to be caught under section CI 2(1), the purpose of the employer must have been to provide the employee with a benefit. This part of the commentary considers whether the test to determine if the employer has entered into the arrangement for the purpose of providing a benefit should be a subjective or an objective one.

A subjective approach requires consideration of the intention or motive of the parties in entering into the arrangement. In the current context, a subjective test will look at what the particular employer had in mind when the arrangement with the third party was entered into. An objective approach however may consider what a reasonable person in the position of the employer ought to have had in mind.

Additionally, case law, particularly in the area of GST, indicates that the correct test for determining purpose is a mixed subjective/objective test, considering both subjective and objective factors in reaching a conclusion as to the taxpayer's purpose.

In a number of cases the courts have held that the test for purpose is dependent on the statutory context in which it is found (see, for example *CIR v Haenga* (1985) 7 NZTC 5,198).

It is therefore obvious that it is necessary to look closely at the wording of the section. Section CI 2(1) does not contain the word "purpose". Section CI 2(1) requires that the employer and the third party have "entered into an arrangement for that benefit to be so provided".

In the Commissioner's view, section CI 2(1) requires consideration of the reason that the employer "entered into" the "arrangement" with the third party. This means that the test to determine the employer's purpose in entering into the arrangement should be a subjective one, looking at the particular reasons that the employer had in mind. However, objective factors can be taken into account to aid in this interpretation.

This approach could be seen as being supported by McCarthy J in *G v CIR* [1961] NZLR 994 where he held that the word "for" points to intention, clearly indicating a subjective approach. At page 999, McCarthy J stated:

> "For" points to intention. …the essential test as to whether a business exists is the intention of the taxpayer as evidenced by his conduct, and that the various tests discussed in the decided cases are merely tests to ascertain the existence of that intention. I think that it conforms with this approach to construe the word "for", when considering a phrase such as "carried on for pecuniary profit" used in relation to an occupation, as importing intention.

Therefore, the test to determine the employer's purpose is a subjective one looking at the intention of the employer, but objective factors should be considered to ensure that the employer's stated purpose is honestly held. That is to say that for section CI 2(1) to apply, the reason that the employer entered into the arrangement must have been to provide a benefit to its employee.

What test should be used to determine the employer's purpose?

This part of the commentary considers the appropriate test to be used in determining the purpose of the employer in entering into the "arrangement" with a third party.

There is a spectrum of tests that could be used to determine the purpose of the employer in entering into the arrangement.

At one end of the spectrum is a sole purpose test, which would require that the sole or only purpose of the employer in entering into the arrangement must be the provision of the benefit. In the Commissioner's opinion, this would be an unduly restrictive test for section CI 2(1), as it would not apply in any situation where there was another purpose, no matter how secondary or minor.

At the other end of the spectrum is the test that the section will apply if **any** of the purposes of the employer in entering into the arrangement is that the employee be provided with a benefit. In the Commissioner's opinion, this is also not an appropriate test in the context of section CI 2(1), as the section would catch all benefits that were provided to employees if the employer had some form of arrangement with the third party, and the fact that the employees were receiving a benefit had crossed the employer's mind when they entered into the arrangement with the third party. If the provision of the benefit is not a part of the arrangement between the parties, but is truly incidental to the purpose of the employer, then the section should not apply.

Between these two extremes are the dominant purpose test and the more than incidental purpose test.

A dominant purpose test would require that the **main** reason for the employer entering into the arrangement be the provision of the benefit to the employee. This test would allow the employer to have other purposes in entering into the arrangement, but that, in order for the section to apply, the main purpose of the employer in entering into the "arrangement" needs to be the provision of a benefit. This test would also mean that if the employer had more than one purpose in entering into the "arrangement" and the provision of a benefit to employees was not the most important purpose, then section CI 2(1) would not apply.

There are a number of cases that have determined that the word "purpose" used on its own in statutory language without any apparent qualifier means the dominant purpose of the taxpayer, for example, in relation to the third limb of section CD 4 (and predecessor provisions) and in relation to section 108 of the Land and Income Tax Act 1954 (the former section BG 1).

In the Commissioner's opinion, there is no reason to conclude that section CI 2(1) requires a dominant purpose test. There is no indication on the words of section CI 2(1) that a dominant test is necessary. This can be contrasted with section CD 4, where the section clearly refers to **the** purpose. Therefore, it is the Commissioner's opinion that it would not be appropriate to apply a dominant purpose test in determining whether section CI 2(1) applies.

A more than incidental purpose test would be similar to the test contained in section BG 1, where, as long as the purpose of providing a benefit is more than incidental to any other purpose of the employer in entering into the "arrangement", the section will apply. In the context of section CI 2(1), this means that if the provision of the benefit is incidental to other purposes of the "arrangement", such as the provision of credit cards to employees, or obtaining a good package deal for the employer, then the section would not apply. The use of this test could be seen as being supported by the fact that section CI 2(1) is an anti-avoidance provision, and that it is appropriate to have a similar test as in other avoidance contexts. Alternatively, it could be argued that a more than incidental test is not appropriate, as the language of section BG 1 explicitly provides for the test of more than merely incidental in the legislation itself, whereas section CI 2(1) does not.

Overall, it is the Commissioner's opinion that this is the appropriate test to be adopted in interpreting section CI 2(1). This approach would mean that if the purpose of providing a benefit to the employees is no more than incidental to some other purpose of the employer in entering into the arrangement, the arrangement would not be caught within the section. A more than incidental test means that the purpose of the employer must be significant in order for the benefit to be caught within the section, but does not need to be the most important (or dominant) reason or purpose of the employer in entering into the "arrangement".

In the Commissioner's opinion, if an employer has more than one purpose when they enter into the "arrangement" with the third party, it is considered appropriate to exclude incidental purposes from section CI 2(1), but there is no reason why an employer with a significant, but not dominant, purpose of providing a benefit to employees should not be caught by the section.

Therefore, to establish if section CI 2(1) applies, it is necessary to look at what the arrangement between the employer and the third party is for, and whether the provision of the benefit to employees is incidental to another purpose of the employer, or whether it is a separate, significant, purpose in its own right. If the provision of a benefit is no more than incidental to some other purpose of the employer in entering into the arrangement with the third party, then section CI 2(1) will not apply.

It is noted that the relevant consideration is whether the purpose of the employer of providing a benefit to employees is incidental to another purpose of the employer, not whether the benefit received is incidental to the arrangement entered into. It is the purpose of the employer that is relevant, not the purpose of the arrangement.

If the employer does not have a purpose of providing a benefit to employees (or the purpose is not more than incidental), section CI 2(1) will not apply to any benefit that may be provided by a third party.

Which "arrangement" must be the one "for" the benefit?

In most cases where a benefit is provided to an employee by a third party, there will be an "arrangement" between the employee and the third party that is "for" that benefit to be provided. It could be argued that because the arrangement between the third party and the employee may be "for" the benefit to be provided, then no matter what degree of negotiation or other interaction occurs, the third party/employer arrangement will not also be "for" the provision of a benefit unless consideration is provided to the third party by the employer.

This argument focuses on which arrangement actually provides for the benefit to be provided. If the "arrangement" between the employer and the third party is not **for** a benefit, then section CI 2(1) will not apply. Any arrangement that may exist between the third party and the employee will be "for" a benefit, as it is the third party that must provide a benefit to the employee for the purposes of the section.

Section CI 2(1) requires that the third party must be a person "with whom the employer of the employee has entered into an arrangement for that benefit to be so provided". This does not require consideration of any arrangement that may exist between the third party and the employee. The fact there is an arrangement between the third party and the employee which is "for" the provision of a benefit, does not mean that it is not also possible for the employer to be party to that or another such arrangement.

For there to be an "arrangement" between the employer and the third party "for" the provision of a benefit, in the Commissioner's view, as a minimum, the employer must request or instruct a third party to provide a benefit. When this has occurred, it is the Commissioner's opinion that the subjective purpose of the employer in entering into the arrangement is to provide a benefit, and therefore the arrangement is "for" the provision of a benefit, as required by the section. The employer's activity in requesting or instructing is, in the Commissioner's view, a sufficient level of involvement or activity by the employer to make the employer/third party arrangement an arrangement that is "for" the benefit to be provided. The arrangement will obviously also be "for" the benefit to be provided where consideration passes between the employer and the third party.

There appears to be no reason to conclude that merely because the arrangement between the third party and the employee is for the provision of a benefit, that it is not also possible for the employer to be party to that or another such arrangement.

What is required for there to be a benefit to the employees?

Under section CI 1, the definition of what amounts to a fringe benefit is very broad, and is intended to include all non-cash payments made by an employer to an employee in respect of their employment. However, it is not clear whether, given that section CI 2(1) is an anti-avoidance provision, what the employee receives from the third party needs to be a benefit that the employee would not usually be able to receive or if something else is needed. The issue arises of whether a benefit under section CI 2(1) must be something that the general public are unable to receive.

In *Case M9* (1990) 12 NZTC 2,069, Bathgate DJ held that the provision of the motor vehicle was subject to FBT and stated (at page 2,073) that:

> A benefit is often regarded as being given voluntarily, rather than compulsorily. A benefit may however be given under compulsion in some circumstances – *Yates v Starkey* [1951] 1 All ER 732…"Fringe benefits" are defined in s 336N(1) of that Act as the benefits "received or enjoyed", in the sense that it is from the employee's view they are to be considered a benefit, which is the object and purpose of such.

In *Case M59* (1990) 12 NZTC 2,339 Bathgate DJ stated (at page 2,343):

> Only the receipt or enjoyment occurred after FBT was imposed, but that was not sufficient, as that is only a part of a fringe benefit, and not the whole fringe benefit. By 31 March 1985 the objector had provided a benefit, although it was not enjoyed by B and C until after that date. That enjoyment however was not for the purposes of the Act a fringe benefit. Although the objectors would be taxable in that period after 1 April 1985, they were not subject to the tax because when the benefit was provided by them it was not chargeable to FBT.

This means that there are two separate elements that must exist in order for there to be a "benefit" for FBT purposes: provision to the employee and enjoyment by that employee. Accordingly, for a benefit to exist under section CI 2(1), there must be both the provision of something by a third party who has entered into an arrangement with the employer to provide that benefit, and enjoyment by the employee.

Accordingly, on the basis of the above cases, all that is necessary for there to be a benefit to an employee under section CI 2(1) is for the employee to receive, or be provided something by a third party, and to enjoy, or take advantage of, that thing. There is no requirement that a fringe benefit must be something that the employee could not receive on his or her own account, or that the general public cannot receive provided that the requirements of the definition in section CI 1 are met and the benefit is provided in respect of the employment of the employee.

This interpretation is supported by the scheme of the FBT rules. Section CI 1 defines the term "fringe benefit" very broadly. It is not necessary for the purposes of the FBT rules for the benefit to be something that the employee could not otherwise be able to receive or that the public is unable to receive. All that is required is that something needs to be provided to the employee that falls within the definition of "fringe benefit" in section CI 1. In the Commissioner's opinion, this applies equally to section CI 2(1). If something is provided to the employee by a third party that would have been a fringe benefit had it been provided by the employer, it will be subject to FBT by virtue of section CI 2(1).

Therefore, for there to be a benefit under section CI 2(1) all that is required is that a "fringe benefit" (as defined in section CI 1) is provided to the employee by a third party (in addition to regular salary or wages) pursuant to an arrangement between the employer and the third party for the provision of that thing, and the employee must take advantage of or use that thing.

Meaning of "provision"

Another requirement of section CI 2(1) is that the arrangement be for the benefit to be so "provided". For a benefit to be caught under section CI 2(1) it must have been provided to the employee by the third party. It is not sufficient that there is an "arrangement" between the parties that is merely for access to premises, the "arrangement" must be "for" the provision of a benefit for section CI 2(1) to apply.

The *Oxford English Dictionary* (10th Edition, 1999) defines the term "provide" as "make available for use; supply". There have been a number of cases that discuss the meaning of the word "provide".

These cases show that the meaning of "provide" depends on the facts and circumstances of each case. For example, in *Ginty v Belmont Building Supplies Ltd* [1959] 1 All ER 414, Pearson J stated, at page 422:

> I do not think that there is any hard and fast meaning of the word "provided"; it must depend on the circumstances of the case as to what is "provided" and how what is "provided" is going to be used.

In *Norris v Syndi Manufacturing Co Ltd* [1952] 1 All ER 935, an employee had removed the safety guard from a machine in order to carry out tests. His employer was aware that the employee took the guard off to test the machine, and had told him to replace it "after testing and before operation". The employee inadvertently injured himself while working without the guard one day. The Court of Appeal found that the guard had been "provided" by the employer, and that the duty to provide the guard did not require that the employer should have to order the workmen to use it. Romer LJ stated, at page 940:

> The primary meaning of the word "provide" is to "furnish" or "supply", and accordingly, on the plain, ordinary interpretation of s. 119 (1), a workman's statutory obligation is to use safety devices which are furnished or supplied for his use by his employers.

The meaning of "provide" has been considered by the Employment Court of New Zealand in *Tranz Rail Ltd (T/A Interisland Line) v New Zealand Seafarers' Union* [1996] 1 ERNZ 216. In that case, the issue was whether a statutory requirement that the employer provide food and water to the seafarers meant that the employer had to provide them with free food and water, or just ensure facilities were available for the employees to have access to food and water. Colgan J, at page 227, stated:

> The applicant's principal argument is that the plain words of the statute allow an employer of seafarers either to agree to provide food and water without cost to an employee or to do otherwise whether by negotiation as part of a collective employment contract or by the imposition of charges for such provisions. Ms Dyhrberg submitted that to achieve an interpretation as sought by the respondents, the Court would be required to add to the statutory words a phrase such as "without cost to such employees" or the like. Ms Dyhrberg submitted that the word "provide" means make available but no more. Counsel conceded that this interpretation would mean that an employer of seafarers would be entitled to charge an employee for water consumed, although stressed that such an outcome would be unlikely in any event.
>
> Ms Dyhrberg submitted that to "provide" is to provide the opportunity of having the appropriate supplies of food and water. I find however that in this context the natural and ordinary meaning of the word "provide" in relation to food and water on ships is to supply without cost to the recipient seafarer.

The Australian Administrative Appeals Tribunal in *Pierce v FCT* 98 ATC 2240, considered whether a car had been provided to an employee. At page 2247, the Tribunal stated:

> There is no reason why "provides" should not be given its ordinary English meaning, namely "to furnish or supply" (Macquarie Dictionary).

In order for something to have been "provided" to an employee by a third party in the context of section CI 2(1), it must be supplied, furnished or made available to that employee.

Conclusion on the scope of section CI 2(1)

For an "arrangement" to fall within section CI 2(1), it is not necessary that consideration passes from the employer to the third party. The section will apply and FBT be payable where less has occurred. However, if consideration does pass between the employer and the third party in respect of the benefit, then the section will apply.

For section CI 2(1) to apply, the "arrangement" between the employer and the third party must have been entered into by the employer "**for**" the benefit to be provided to the employee. The term "arrangement" is very wide in its application. The word "for" means that the relevant consideration is the subjective purpose of the employer in entering into the "arrangement", and that the purpose of providing a benefit to employees must be more than incidental to some other purpose of the employer. The word "provide" means to supply, furnish or make available.

It is concluded that these requirements will be fulfilled, and that section CI 2(1) will apply in the following situations:

- Where consideration passes from the employer to the third party in respect of the benefit being provided.
- Where the employer requests (other than merely initiating contact), instructs or directs, the third party to provide a benefit.
- Where there is negotiation or discussion between the employer and the third party which (explicitly or implicitly) involves the threat or suggestion that the employer would withhold business or other benefits from the third party unless a benefit is provided to the employees.
- Where the third party and the employer are associated parties, and there is a group policy (whether formal or informal), or any other agreement between the associated parties, that employees of the group will be entitled to receive benefits from the other companies in the group.

It is noted that the Commissioner does not consider that all situations involving associated persons will necessarily fall within section CI 2(1). It is only in those situations where there is a group policy, or any other agreement between the associated parties, regarding the provision of benefits that the Commissioner considers that the section will apply.

Provided that none of the above situations exists, it is concluded that section CI 2(1) will not apply in the following situations:

- Where there is negotiation or discussion between the employer and the third party that results in no more than:
  - (i) the employer granting the third party access to the premises or work environment to discuss the benefit with employees; and/or
  - (ii) agreement between the parties as to the level of benefit that is to be offered by the third party to employees; and/or
  - (iii) the employer agreeing to advertise or make known the availability of the benefit.
- Where the employer has done no more that initiate contact or discussions with the third party.
- Where there is no significant contact or arrangement between the employer and the third party.

It is noted that a consequence of this conclusion may be that the employer is required to put into place systems to enable them to obtain the relevant information required to fulfil their FBT obligations. In the Commissioner's opinion, where the employer is involved in the types of arrangement contemplated by the first four of the bullet points set out above, the employer will generally be in a sufficient relationship with the third party to obtain the information they require to fulfil their obligations. The onus is on employers who are involved in arrangements for the provision of benefits in any of these ways to ensure that they can do so (for example, by requiring this of the third party).

Salary sacrifice situations

This Ruling does not consider or rule on the taxation implications of salary sacrifice situations. In the context of the Ruling, this would include situations where the remuneration given by an employer to an employee is reduced due to a benefit being received by the employee from the third party (or due to the possibility of a benefit being received), or where the remuneration of the employee otherwise takes the receipt of a benefit provided by a third party into account.

It is considered that different considerations may apply to the tax treatment of such situations, for example, the benefit may have been provided by the employer in such a situation, or there may be other relevant aspects of the arrangement, and this Ruling has not considered the taxation implications of salary sacrifice situations.

Comments on technical submissions received

Submissions were received from a number of commentators that the conclusion reached in the previous draft ruling would lead to enforceability or workability problems in practice. These matters have been given serious consideration. It is the Commissioner's opinion that the conclusions reached in this draft ruling should not generally give rise to unworkable or unenforceable results. If the circumstances referred to in the first four bullet points referred to in the draft ruling exist, it is considered that the employer will be in a sufficient position to require that systems be put into place to ensure that they have access to the relevant information required to fulfil their FBT obligations. Therefore, it is considered that the conclusions will not give rise to unworkable or unenforceable results. As noted previously, the onus is on employers who are involved in arrangements for the provision of benefits in any of these ways to ensure that they can obtain the necessary information (for example, by requiring this of the third party).

One submission was received regarding the use of the FBT prescribed rate of interest in the examples. It was considered that this would mean that there would technically often be a benefit to employees, even if the interest rate offered was what was considered to be a market rate. This submission has also been given serious consideration. It is considered that this result is a consequence of the normal way in which the FBT rules operate, by prescribing a rate of interest to be used in determining the value of the benefit, and is not due to the conclusions reached in the draft ruling.

We also received a number of comments regarding the interaction between section CI 2(1) and the FBT valuation provisions. However, these issues are outside the scope of this Ruling.

Examples

The following examples are included to assist in explaining the application of the law.

These examples all assume that there has been no sacrifice of salary by the employee receiving the benefit.

Example 1

ABC Bank wishes to offer the employees of XYZ Ltd a low-interest loan facility. ABC approaches XYZ, who agrees to ABC's offer, and also agrees to pay ABC the difference between the interest rate offered to employees, and the current market interest rate.

This is clearly subject to section CI 2(1), and FBT will be payable on the difference between the rate paid by XYZ's employees and the FBT prescribed rate of interest. An "arrangement for" exists between ABC and XYZ, and the purpose of the employer is to allow the provision of a benefit to XYZ's employees. This is evidenced by the fact that consideration has been passed between the employer and the third party in respect of the benefit being provided.

Example 2

A credit card company approaches the manager of BCE, and asks whether BCE would allow them to approach BCE's employees to offer them credit cards (for the employees' personal use). The credit card company proposes that all staff members who choose to receive cards will be allowed to join the credit card company's loyalty scheme (which has no joining fee, but is only available to selected cardholders). BCE agrees to this request, but suggests that the credit card company might wish to provide a slightly discounted interest rate to the employees, so that the offer does not waste the employees' time. The credit card company agrees to this change. BCE provides no consideration to the credit card company. The credit card company is keen to secure BCE employees as customers and is happy to agree to offer the employees the additional benefits.

Here, there is an "arrangement" between the employer and the third party. There is a meeting of minds, and that meeting of minds extends to future action. However, section CI 2(1) will not apply in this situation. The meeting of minds does not include the provision of a benefit, but merely allows the credit card company access to BCE's employees to offer them a benefit. The main purpose of the employer in entering into the arrangement is to allow the credit card company to offer a benefit to their employees which will be of potential interest to the employees. The provision of a benefit, if it is a purpose of the employer, will be incidental to this. Therefore section CI 2(1) will not apply and no FBT will be payable on any benefit received by the employee from the credit card company.

Example 3

A local retailer approaches MNO Ltd, and asks permission to display advertising brochures on MNO's premises, and for MNO to place an advertisement on the company's intranet. MNO agrees, after only a cursory inspection of the brochures and advertisement. MNO also agrees to allow the retailer to email interested staff with updated specials (staff are given the opportunity not to receive the email updates). The brochures, and subsequent emails, invite the employees to join a loyalty programme, which gives them the possibility of receiving rewards.

As above, there will be an "arrangement" between the employer and the third party, as there is consensus as to future action. However, the arrangement will not be "for" the provision of a benefit. The employer has only agreed to allow the third party access to its employees, and this is their main purpose in entering into the arrangement. Any purpose the employer may have of benefiting their employees is incidental to this purpose. The "arrangement" is "for" access to the employer's premises or to allow the third party to communicate with the employees directly or by electronic means, not to provide a benefit to employees. Hence, section CI 2(1) will not apply, and no FBT will be payable on any reward received by an employee under the loyalty programme.

Example 4

BB Ltd is a large company with a number of high net worth employees. BB contacts its bank and requests that the bank offer a low interest mortgage facility to the employees of BB, which also permits an employee to obtain a mortgage with a smaller deposit than would normally be required. BB believes that the bank will agree to this request as BB has a lot of business with the bank. Additionally, it is expected that the bank will get a great deal of business from the employees of BB, as BB have told the bank that they are aware of a reasonable number of staff members who would be interested in such a facility. The bank is attracted by the level of business it may achieve with the employees, and is also keen to maintain the good relationship it has with BB, so puts together a proposal which it presents to BB. BB considers that the proposal is worthwhile, so asks the bank to make the facility available to employees. BB also agrees to help promote the facility by putting up posters and making brochures available in the workplace, and also by sending an email to staff informing them of the facility.

Here, there is an "arrangement" between BB and the bank which is "for" the provision of a benefit to employees. There is a meeting of minds between the parties that extends to the provision of a benefit to employees. BB has not simply entered into the arrangement with the purpose of allowing the Bank access to the employees. Rather, BB has entered into the arrangement with a more than incidental purpose of providing employees with a benefit. This is evidenced by the fact that BB has an expectation that the Bank would comply with their request and because they are aware of a number of staff members who would be interested in the facility. Therefore section CI 2(1) will apply, and FBT will be payable on the difference between the interest rate paid by employees and the FBT prescribed rate of interest.

Example 5

STU and VWX are both companies in the same group of companies. The group has a widely understood policy that all companies in the group will provide discounted products or services to all employees of companies in the group, although this policy has never been put into writing. STU therefore provides interested employees of VWX with discounts on their products.

Here, there will an "arrangement" for the provision of a benefit, and VWX will be liable to FBT on any benefits received by its employees from STU. There is a group policy that each company will provide the employees of the other companies in the group with benefits. Therefore, there is an understanding between the employer and the third party that each will act in a particular way, that understanding extending to the provision of a benefit, and the purpose of the policy is to allow employees to be provided with benefits by a third party. Therefore section CI 2(1) will apply.

Example 6

DFG, a travel agent, employs a number of staff, and enters into a scheme with YTR, an airline, to strengthen their relationship. The scheme involves YTR agreeing to give a certain number of free domestic flights per year to employees of DFG who excel in promoting and selling YTR flights. In return, DFG agrees to have their employees promote YTR flights, and convert flights to YTR wherever possible. In order to determine which employees are entitled to free flights, DFG awards its staff with points for outstanding customer service. Once a staff member has accumulated the required number of points, they are entitled to a free flight from YTR. There is no cost to DFG for those flights.

Here, section CI 2(1) will apply. There is an "arrangement" between the parties, as there is a consensus between DFG and YTR that involves the provision of a benefit to employees. One of the main purposes of DFG in entering into the arrangement is to provide the staff with free flights. Although DFG have another significant purpose in entering into the arrangement, which is to strengthen their relationship, the purpose of providing a benefit to employees is not incidental to that purpose. Therefore, FBT will be payable by DFG on the value of the flights.

Example 7

HJK is a large nationwide employer with a large number of staff. A senior manager of HJK approaches LMN, a nationwide chain of retail stores, and suggests that they may like to consider offering a discount to employees of HJK. LMN agree to consider this idea, and later decide to allow a 10% discount to all staff of HJK at all of their stores (this is achieved by providing all employees with a discount card). HJK does not give any consideration for this, has made no suggestion that they will do business with LMN themselves if a discount is permitted, and have not been involved in discussions as to the level of the discount, or any other details of the offer. LMN has decided to offer the employees the discount as they believe they will obtain a substantial amount of business.

Section CI 2(1) would not apply in this situation. There is no "arrangement" between the parties that encompasses the provision of the benefit, as the only consensus as to future action is that LMN agreed to consider the idea. HJK has done no more than initiate discussions with LMN, and the decision to offer a benefit to employees was made unilaterally by LMN. Although the purpose of HJK could be argued to be the provision of a benefit, there is no "arrangement" with LMN that is "for" such provision.

Example 8

An employee works for a company. She obtains a personal credit card and joins its associated points reward scheme. Under that scheme she can accumulate points as goods and services are charged on the credit card. After the employee accumulates 10,000 points, she can transfer those points, at her option, to any one of a number of airlines' frequent flyer schemes affiliated to the credit card company's points reward scheme. Once she accumulates a specified number of points on the airline frequent flyer scheme, she can exchange them for free or discounted travel.

In the course of her work she incurs a number of employment-related charges on the credit card as well as private expenditure. The employee accumulates points on the credit card points reward scheme for both types of expenditure. She very soon reaches the specified threshold of points, and transfers them to a particular airline's frequent flyer scheme, exchanging them for a free trip to Fiji.

The company does not have an FBT liability, as section CI 2(1) will not apply. The receipt of the points under the credit card company's points reward scheme is because of the contractual arrangement between the credit card company and the employee. No arrangement exists between the employer and the credit card company to provide the employee with entitlements under its points reward scheme or the associated airline's frequent flyer scheme. It does not matter that some of the points that give the entitlement result from employment related expenditure.

Example 9

The following year the employee obtains promotion in the company and receives a corporate charge card on which she is specified as the cardholder. The charge card is from a different company to that which issued her personal cards. This particular charge card company also allows cardholders to join in its points reward scheme. The employee joins as an individual member and pays the membership fee personally. The employee's employer is not involved in encouraging the employee to join the scheme. This scheme also allows an accumulation of points as goods and services are charged on the card and a transfer of points, subject to certain conditions, to a participating airline frequent flyer scheme.

Section CI 2(1) will not apply to this example and the employer does not have an FBT liability on any entitlement received by the employee under the credit card company's points reward scheme. There is no arrangement between the employer and the credit card company to provide entitlements to the employee under the points reward scheme. The employee receives those entitlements because of her contractual relationship with the credit card company.

Example 10

QRS is an employer, and wants to purchase a number of motor vehicles for use in their business. The company approaches a motor vehicle dealer and negotiates a discount on the vehicles it purchases. QRS tells the dealer that it has a substantial number of employees who would like to purchase vehicles, and who it expects would be induced to buy them from the dealer if they were offered the same discount. The dealer agrees that it will offer the employees the same discount if they wish to buy vehicles from it.

Here, the employer has requested that the dealer provide their employees with a discount on any vehicles purchased. There is an arrangement between the third party and the employer that is for the provision of a benefit. Although the dominant purpose of the employer may be to obtain a benefit for themselves, the purpose of the employer in asking the dealer to offer the same discount to their employees could not be said to flow from this purpose. Therefore a more than incidental purpose of the employer in entering into the Arrangement is the provision of a benefit, and the section will apply.

TRADING STOCK – TAX TREATMENT OF SALES AND AGREEMENTS TO SELL

PUBLIC RULING – BR PUB 04/06

Note (not part of ruling): This ruling is essentially the same as public ruling BR Pub 98/8 previously published in *Tax Information Bulletin* Vol 11, No 1 (January 1999). BR Pub 04/06 applies from 1 April 2003 to 31 March 2008. BR Pub 98/8 applied until the end of the 2002 income year.

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

Taxation Laws

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

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

The Arrangement to which this Ruling applies

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

How the Taxation Laws apply to the Arrangement

The Taxation Laws apply to the Arrangement as follows:

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

The period for which this Ruling applies

This Ruling will apply from 1 April 2003 until 31 March 2008.

This Ruling is signed by me on the 27th day of May 2004.

Martin Smith
General Manager (Adjudication & Rulings)

COMMENTARY ON PUBLIC RULING BR PUB 04/06

This commentary is not a legally binding statement, but is intended to provide assistance in understanding and applying the conclusions reached in public ruling BR Pub 04/06.

Background

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

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

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

Legislation

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

Section CD 3 states:

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

Section FB 3 states:

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

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

Application of the legislation and case law

Which section applies?

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

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

History of section FB 3

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

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

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

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

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

Interpretation of section FB 3

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

The general principle that income is derived when it is earned, and that such time will be when there is an entitlement to payment or a legally enforceable debt, was also applied in *Hawkes Bay Power Distribution Ltd v CIR* (1999) 19 NZTC 15,226. In that case Richardson P delivered the judgment of the Court of Appeal which essentially agreed with Goddard J's conclusion in the High Court that the taxpayer's income was derived at the contemporaneous point in time the electricity was supplied by the taxpayer and consumed by its customers. The Court of Appeal considered that the income earning process was complete on supply and sale of the electricity to the consumer.

Sales of land

Section OB 1 provides that generally, land is not considered to be trading stock, however the definition also states that in limited circumstances (sections EE 19, FF 13, GD 1 and GD 2 when any amount derived from the sale or disposal would be gross income to which sections CD 1 applies) land may be trading stock. If a particular sale of land was within these provisions it would be considered for those purposes to be trading stock and therefore the ruling it may be applicable if it was unclear from the contract when the sale or disposal was to take place.

Although land is not generally trading stock as defined in section OB 1 (or subject to the Sale of Goods Act), it is worth noting that the same general principles in relation to derivation apply to the sale of land, or where the contract is otherwise an executory contract. However, although the applicable derivation principles are the same for land as for other property, the exact timing of when income is earned and a legally enforceable debt arises may be different. The difference will arise where the contract has an executory nature, and the vendor is not legally entitled to sue for the purchase price until after settlement. For a more in-depth discussion of the principles of derivation in relation to "sales of land by business taxpayers who provide vendor finance" and the case of *Gasparin v FCT* (1994) 94 ATC 4,280, refer to the QWBA of this title which was published in the *Tax Information Bulletin* Vol 16, No 5 (June 2004) (see page 34).

The case of *Gasparin v FCT* (1994) 94 ATC 4,280 specifically addressed the question of when income from the sale of the land was "derived". In delivering the judgment of the Full Federal Court, von Doussa J concluded that ordinary derivation principles applied, but on the facts of the case, a legally enforceable debt did not arise until the date of settlement and conveyance (when the executory contract was executed). Before this date, the vendor merely had a right to sue for specific performance of the contract, but not for the debt itself.

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

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

It must be remembered however, that the facts of each case need to be examined, rather than assuming all executory contracts will automatically result in derivation occurring on settlement. If the facts of a case clearly show an earlier debt (rather than being able to sue for specific performance) and/or passing of property, the time of derivation will be earlier.

When stock is "sold or otherwise disposed of"

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

Sale of Goods Act 1908

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

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

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

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

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

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

(a) The timing when the parties agree

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

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

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

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

Date of sale for section FB 3

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

Case law

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

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

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

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

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

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

When a contract is unconditional

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

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

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

The Courts of New Zealand have sought to establish the intentions of the parties to the contract to ascertain whether it was intended that the condition be one which needed to occur prior to the contract coming into existence (a condition precedent) or whether the condition was one which was to occur after the contract came into existence (a condition subsequent). The Court of Appeal in *Hunt v Wilson* [1978] 2 NZLR 261 was reluctant to simply rely on the labels "conditions precedent" and "condition subsequent", and instead considered that it was necessary to look at the parties to the contract to ascertain whether or not a contract has come into existence.

The accrual rules

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

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

If the accrual rules do apply, the approach in the ruling will apply in relation to the consideration that is effectively attributed by the Act to the property sold (as distinct from any deemed financial arrangement income or expenditure that arises by virtue of section EH 1 (Division One) or sections EH 33-36 (Division Two)).

Examples

Example 1

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

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

Example 2

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

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

Example 3

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

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

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

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

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

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

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

Example 4

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

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

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

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

Example 5

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

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

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

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

LEGISLATION AND DETERMINATIONS

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

NATIONAL AVERAGE MARKET VALUES OF SPECIFIED LIVESTOCK DETERMINATION 2004

This determination may be cited as "The National Average Market Values of Specified Livestock Determination, 2004".

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 2003–2004 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 2003–2004 income year, are 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	66.00
	Ram and wether hoggets	59.00
	Two-tooth ewes	98.00
	Mixed-age ewes (rising three-year and four-year old ewes)	85.00
	Rising five-year and older ewes	68.00
	Mixed-age wethers	46.00
	Breeding rams	149.00
Beef cattle	*Beef breeds and beef crosses*	
	Rising one-year heifers	353.00
	Rising two-year heifers	548.00
	Mixed-age cows	624.00
	Rising one-year steers and bulls	433.00
	Rising two-year steers and bulls	621.00
	Rising three-year and older steers and bulls	777.00
	Breeding bulls	1,404.00
Dairy cattle	*Friesian and related breeds*	
	Rising one-year heifers	529.00
	Rising two-year heifers	732.00
	Mixed-age cows	817.00
	Rising one-year steers and bulls	332.00
	Rising two-year steers and bulls	512.00
	Rising three-year and older steers and bulls	678.00
	Breeding bulls	895.00
	Jersey and other dairy cattle	
	Rising one-year heifers	364.00
	Rising two-year heifers	647.00
	Mixed-age cows	766.00
	Rising one-year steers and bulls	271.00
	Rising two-year and older steers and bulls	422.00
	Breeding bulls	718.00

Type of livestock	Classes of livestock	Average market value per head $
Deer	*Red deer*	
	Rising one-year hinds	82.00
	Rising two-year hinds	194.00
	Mixed-age hinds	222.00
	Rising one-year stags	110.00
	Rising two-year and older stags (non-breeding)	213.00
	Breeding stags	1,168.00
	Wapiti, elk, and related crossbreeds	
	Rising one-year hinds	108.00
	Rising two-year hinds	227.00
	Mixed-age hinds	261.00
	Rising one-year stags	135.00
	Rising two-year and older stags (non-breeding)	249.00
	Breeding stags	1,130.00
	Other breeds	
	Rising one-year hinds	37.00
	Rising two-year hinds	68.00
	Mixed-age hinds	80.00
	Rising one-year stags	56.00
	Rising two-year and older stags (non-breeding)	93.00
	Breeding stags	229.00
Goats	*Angora and angora crosses (mohair-producing)*	
	Rising one-year does	32.00
	Mixed-age does	45.00
	Rising one-year bucks (non-breeding)/wethers	26.00
	Bucks (non-breeding)/wethers over one year	27.00
	Breeding bucks	126.00
	Other fibre and meat-producing goats (cashmere or cashgora-producing)	
	Rising one-year does	29.00
	Mixed-age does	46.00
	Rising one-year bucks (non-breeding)/wethers	23.00
	Bucks (non-breeding)/wethers over one year	29.00
	Breeding bucks	114.00
	Milking (dairy) goats	
	Rising one-year does	150.00
	Does over one year	250.00
	Breeding bucks	200.00
	Other dairy goats	25.00
Pigs	Breeding sows less than one year of age	174.00
	Breeding sows over one year of age	230.00
	Breeding boars	247.00
	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)	140.00

This determination is signed by me on the 25th day of May 2004.

Martin Smith
General Manager (Adjudication & 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.

JUDICIAL REVIEW IN DEBT CASES

Case:	MW Raynel and Inforest Training Ltd v CIR
Decision date:	23 April 2004
Act:	Tax Administration Act 1994
Keywords:	Judicial review, debt proposals, care and management

Summary

The plaintiffs sought judicial review of the Commissioner's decision to reject two repayment proposals. The Court dismissed the application.

Facts

This is the first application for review which has arisen since section 176 of the TAA was amended along with the general review of the debt and hardship rules.

Mr Raynel owes IRD $32,000 in PAYE arrears. The company owes $28,134.78 for unpaid PAYE, GST and income tax. All amounts are undisputed.

In 2003, various proposals were put forward by Mr Raynel and the company for repayment of all or some of the debt, which were rejected.

Both taxpayers sought judicial review of the decisions made by the Commissioner to reject the offers on the grounds the Commissioner had breached his duty under section 176 of the TAA to maximise the recovery of outstanding tax.

The taxpayers submitted that the Commissioner would have achieved a greater recovery under the offers made than would be possible under a bankruptcy and liquidation.

The Commissioner submitted that the duty under section 176 is not an absolute duty, and is to be read with other obligations imposed upon him by sections 6 and 6A of the TAA.

Decision

The Court held on the law:

(1) Section 176(1) in its current form does not place any greater obligation on the CIR than the duty imposed by section 6A, which is the overriding expression of the duty to collect over time the highest net revenue having regard to the matters defined in section 6A(3)(a),(b) and (c).

(2) Section 176 in its current form does not relieve officers of the Inland Revenue Department from the duty under section 6(1) to use their best endeavours to protect the integrity of the tax system, which must be read alongside the duties in both section 6A and section 176.

The Court held on the facts, the CIR was entitled to view the repayment proposals with a high degree of caution, for the following reasons: Mr Raynel's failure to comply with previous arrangements, his failure to provide information properly requested, his failure to disclose relevant information such as judgments entered against him, his continuing non-compliance with his statutory obligations, both personally and through related entities, and his failure to show good faith by making payments in reduction of the tax.

The judgment contains a discussion of the legislation. This notes:

- First, the Commissioner's duty under section 6A(3) of the TAA applies notwithstanding anything in the Inland Revenue Acts. It is therefore clear that section 6A(3) prevails over other provisions, including section 176.
- Second, the obligation to collect the highest net revenue is not absolute, as the Commissioner is only required to take steps to recover revenue which are practicable and lawful.
- Third, the Commissioner is required to have regard to resources available to him, the importance of promoting compliance (especially voluntary compliance) by all taxpayers, and the compliance costs incurred by all taxpayers.

The Court also noted the broad public interest in the integrity of the tax system and in ensuring that taxpayers meet their obligations. A facet of this is that taxpayers who comply with the statutory requirements are entitled to expect that appropriate and, where necessary, firm action is taken against taxpayers who shirk their obligations. If this is not done, complying taxpayers will justifiably perceive a lack of integrity in the system.

The Court noted the present form of section 176(1) is expressed in mandatory terms, ie the CIR **must** maximise the recovery of outstanding tax, but the provision is expressed to be subject to subsection (2). Section 176(2) immediately qualifies the obligation under subsection (1), and reflects similar considerations in sections 6A(3)(a) and (c). The upshot is the CIR is not obliged to maximise the recovery of tax where to do so would be an inefficient use of resources.

CHALLENGE TO PROCESS OF MAKING ASSESSMENTS DISMISSED

Case:	Sweetline Distributors Ltd & Ors v CIR, CIV-2001-485-712
Decision date:	28 May 2004
Act:	Tax Administration Act 1994
Keywords:	Judicial review, time bar, risk to the Revenue

Summary

The applicants were unsuccessful in their application to have the Commissioner's assessments declared invalid and cancelled. The Commissioner's right to issue assessments when the time-bar was imminent and when he perceived there to be a risk to the Revenue was confirmed.

Facts

The applicants sought judicial review of decisions made by the Commissioner to issue a number of assessments. The review was directed to the process followed by the Commissioner, not to the correctness of the assessments themselves.

In 1988 DFC Financial Services Ltd ("DFC") loaned some $3,000,000 to Alamada Nominees Ltd ("Alamada"). This was secured by a debenture over Alamada's assets. In April 1991 DFC exercised its powers under the debenture and put Alamada into receivership. In June 1991 Alamada and DFC entered into a deed of settlement where, in consideration for certain payments, DFC would not seek payment of the balance owed by Alamada, but would not discharge the liability (a debt park). DFC also undertook to assign the debenture to a person nominated by the guarantors of the loan facility.

Between 1994 and 1998 Alamada claimed interest deductions on the balance said to be owing, and, on the basis that Sweetline Distributors Ltd ("Sweetline") had 100% shareholder commonality with Alamada, Sweetline offset its profit against the losses said to be incurred by Alamada.

In January 2000 the Commissioner commenced a review of the income tax returns of the applicants. One of the issues addressed was Alamada's entitlement to the 1994–1998 interest deductions and Sweetline's consequential entitlement to the loss offsets. The Commissioner issued a notice of proposed adjustment in December 2000 advising that he proposed to disallow the 1994–1998 interest deductions, to assess Alamada for a base price adjustment for the 1993 income year, and to disallow Sweetline's loss offsets.

The applicants issued a notice of response disputing the adjustments.

The Commissioner then discovered that Sweetline had sold its business (its major asset) to another company. It was considered this may have taken place to prevent the Commissioner from collecting money from Sweetline, should the proposed adjustments be upheld. Alamada had been struck off the register at a similar stage in the disputes process and it was considered that a similar thing might happen to Sweetline.

On 13 March 2001, without completing the remainder of the disputes resolution process, the Commissioner issued nine assessments. Of the nine, five would have become time-barred on 31 March 2001. The remaining assessments were to have become time-barred on 31 March 2002, 31 March 2003, and 31 March 2004 respectively. Five of the assessments were issued because of the time-bar, and the other four assessments were issued because of a perceived risk to the Revenue. Notices of proposed adjustments had been issued for all the assessments.

The Commissioner argued that he had the right to issue the assessments because of the time-bar and because of the risk to the Revenue. A failure to assess would amount to a dereliction of his statutory obligations.

The applicants argued that the assessments were not issued because of the time-bar, but because of an erroneous belief held by an officer of the Department that the applicants were attempting to defeat the Revenue by transferring assets from the first applicant. The applicants said that they had been willing to issue time-bar waivers. The assessments were unlawful because they amounted to a failure by the Commissioner to exercise his discretion to terminate the disputes process on an informed factual basis.

The applicants sought a declaration that the assessments were invalid and unenforceable and an order setting them aside.

Decision

Goddard J summarised the facts and the positions of the parties. Her Honour noted that the applicants focused a great deal on the purpose of the disputes resolution process in Part IVA of the Tax Administration Act 1994 and in the relevant TIB. The applicants did not allege that the Commissioner had not complied with any specific provision of the Act, but that he did not have the ability to terminate the disputes resolution process when he did.

Issue 1 – whether the Commissioner acted arbitrarily or unreasonably in issuing the assessments

Goddard J first noted that five out of the nine assessments were shortly due to be time barred and that no waiver had been given. Her Honour noted (at paragraph [29]):

> In light of the CIR's clear statutory duty to assess within time bars, and in accordance with established authority on this point, it is indisputable that his overriding duty was to issue the five assessments that were shortly to become time barred. No waivers had been received by 13 March 2001 … and nor had any advice been given by the applicants that they wished to provide waivers.

Furthermore Her Honour stated (at paragraph [30]):

> [I]t would have been unreasonable to insist that [the Commissioner] should wait in something akin to a 'cat and mouse' game, right up until the 'eleventh hour' until moving to assess. Not to have moved when he did in such circumstances would in my view be unreasonable and clearly have put the Revenue at potential risk.

The Judge then cited a number of authorities for the proposition that the Commissioner has a duty to assess when a time-bar is imminent. In relation to the periods that were not going time-barred Goddard J considered that the Commissioner had a proper foundation for issuing the assessments. Her Honour suggested that it would have been prudent for the applicants to have informed the Commissioner of the company's plans.

Issue 2 – whether the Commissioner acted unlawfully in issuing the assessments

Under this head the applicants argued that once the disputes resolution procedure was commenced, they had a legitimate expectation that the Commissioner would issue a disclosure notice and proceed to adjudication in the absence of "exceptional circumstances". However, the disputants conceded that "exceptional circumstances" would include protection of the Revenue. Goddard J held that there was evidence before the Court which established that there was sufficient information to infer that the Revenue was at risk.

In this case the Commissioner had complied with the mandatory parts of the disputes resolution process. Goddard J concluded (at paragraph [44]):

> [Issuing the assessments was] an action taken in discharge of his duty to ensure that the highest net revenue was protected in the public interest.

Issue 3 – even if the Commissioner had acted unreasonably should the Court now exercise its discretion to stay or set aside the assessments

Goddard J discussed two factors that militated against the Court exercising its discretion to set aside or stay the assessments had she found in the applicants' favour in their challenge to the process followed by the Commissioner.

Firstly, there was an alternative remedy available to the applicants. The assessments were before the Taxation Review Authority ("TRA") for a consideration of the correctness of the assessments. Goddard J also noted that the TRA had the power to cure procedural defects.

Secondly, once an assessment has been made it can only be disputed in accordance with the Tax Administration Act 1994 (section 109). Furthermore, there is an established principle that a correct assessment will not be invalidated because procedures have not been followed or extraneous factors have been taken into account. This is reflected in section 114 of the Tax Administration Act 1994.

SECTION 21 GST ADJUSTMENTS

Case:	CIR v Lundy Family Trust & Behemoth Corporation Ltd, CIV-2003-409-2439
Decision date:	14 May 2004
Act:	Goods and Services Tax Act 1985
Keywords:	Adjustments, change in use

Summary

The Commissioner's appeal of the Taxation Review Authority's decision was dismissed. The High Court held that in this case depreciation was the only cost to be taken into account in making section 21((1) adjustments and that the adjustments were recoverable.

Facts

This case related to adjustments under the old section 21(1) of the Goods and Services Tax Act 1985 ("the Act"). The two disputants, a company and a trust, had purchased a number of properties for the purpose of property development. GST input credits were obtained. The properties were subsequently let out for residential purposes (an exempt activity (section(14(c))).

The Commissioner and the disputants agreed that adjustments were required under section 21(1) of the Act. The parties differed, however, as to the value of the adjustments and as to whether the disputants were entitled to a further input tax credit under section 21(5) once the properties returned to the taxable activity.

In relation to the first issue the Commissioner argued that the properties were applied 100% to the exempt supply when they were let and that therefore all expenses incurred in relation to them came within the "cost of those goods" as required by section 10(8). The costs consisted of interest, rates, insurance, depreciation and maintenance expenses. The disputants argued that only the costs that directly related to the exempt supply should come within section 10(8), as all the other costs were incurred whether the property was let or not. Therefore, the only cost that should be taken into account was depreciation.

In relation to the second issue the disputants argued that the first proviso to section 21(5) meant that they were entitled to a refund of the adjustments when the properties were returned to the taxable activity. The Commissioner agreed with this proposition in relation to one-off adjustments, but not in relation to period-by-period adjustments.

In the Taxation Review Authority ("TRA") Authority Willy found for the disputants on both issues. The Commissioner appealed to the High Court.

Decision

First issue

Chisholm J set out the factual background to the dispute and then summarised the parties' submissions. His Honour referred to *CIR v Morris* [1998] 1 NZLR 344 and *CIR v Carswell* (2001) 20 NZTC 17,149, two High Court cases that had considered section 21(1) in relation to property developers. His Honour noted that those cases held that the principal taxable purpose and the non-taxable purpose could co-exist. The Judge accepted a submission by the Commissioner (which was agreed to by the disputants) that the TRA's finding that there could be two principal purposes was incorrect.

Chisholm J noted that the crucial issue for him to determine was what was "the extent that" the properties were applied to the non-taxable purpose. His Honour noted that in *Case U13* (1999) 19 NZTC 9,147 the TRA had held that properties in a similar situation were applied 100% to the non-taxable activity, though the TRA in this case had reached a contrary conclusion.

On the first issue Chisholm J agreed with the disputants' arguments. His Honour held that a fundamental feature of section 21(1) was that the principal purpose subsists notwithstanding the subsequent purpose. Once a property was purchased with that intention the registered person was "locked into" the cost of holding the property regardless of whether or not the property was tenanted. Any decision to let the property would not alter these commitments, and letting would produce its own costs. The disputants' view was in accordance with the correct interpretation of sections 21(1) and 10(8).

Second issue

In relation to the second issue Chisholm J considered that Giles J's obiter dicta comments in *Morris* (where that Judge had suggested that there could be a recovery of section 21(1) adjustments) were applicable, and that there was no distinction between one-off and period-by-period adjustments. His Honour stated (at paragraph [34]):

> "If the Commissioner's argument is right these taxpayers will have paid GST on an exempt supply despite the fact that the need for the s21(1) claw back disappeared once the principal purpose was consummated and output tax was paid. Put another way, the taxpayers will have suffered the very penalty that s21(5) was designed to avoid."

Chisholm J noted that section 21 did not expressly distinguish between one-off and period-by-period supplies. His Honour stated that "the Commissioner's argument about the taxable supply being 'used up' overlooks that the properties giving rise to the supply … remain in existence."

The Commissioner was thus unsuccessful on both issues.

PURPORTED APPEALS STRUCK OUT

Case:	TRA decision 018/04
Decision date:	3 May 2004
Act:	Taxation Review Authorities Act 1994
Keywords:	Interlocutory decision, strike out

Summary

The Taxation Review Authority struck out a number of purported notices of appeal filed by the disputants as they related to interlocutory decisions.

Facts

This interlocutory decision relates to certain participants of the JG Russell tax avoidance template. The template operated by grouping profitable companies with companies with tax losses so as to relieve the profitable companies of their income tax obligations. The scheme has been described by the Court of Appeal as a "blatant tax avoidance scheme" (*Miller v CIR; Managed Fashions Limited v CIR* (1998) 18 NZTC 13,961).

In this decision Judge Barber dealt with an application by the Commissioner to strike out a number of purported notices of appeal filed by the disputants. The purported appeals related to decisions issued by Judge Barber on 8 January 2004, 16 January 2004 (five decisions) and 17 February 2004 ("the decisions"). The Commissioner's application was based on the fact that the decisions were all interlocutory, and that therefore there was no right of appeal under section 26 of the Taxation Review Authorities Act 1994.

The Commissioner relied on *Case W7* (2003) 21 NZTC 11,049, a related decision where the Authority had struck out another purported appeal of an interlocutory decision.

The objectors argued that the Authority had no jurisdiction to strike out an appeal against one of its own decisions. They argued that once an appeal was filed the Authority only had a ministerial jurisdiction—that is jurisdiction to get the case on appeal in order so the appeal could be heard by the High Court. The Commissioner argued that the Authority had the necessary jurisdiction.

The objectors further argued that there were no "policy and practical reasons" for denying a right of appeal in this situation. It was also suggested that many of the hearings had not really commenced and that the decisions were of a pre-trial character which could have a substantive effect on the hearings as a whole. The Commissioner rejected the objectors' submission that only one of the blocks of objectors had commenced as Mr Russell had been cross-examined on all the objectors, and also submitted that the decisions were ones that were ordinarily made during a hearing (which had here commenced) and should not be subject to interlocutory appeal.

Decision

Judge Barber concluded that he did have the jurisdiction to strike out the appeals. His Honour stated (at paragraph [13]):

> It seems to me that if I consider that there is no jurisdiction for a party to file an appeal against my decision, then I cannot allow the purported appeal to continue to be processed and that I should strike it out as soon as I am aware of its existence, and that I have power to do so.

Judge Barber further agreed that the decisions that he had made were of a type normally made in the course of a hearing and could be appealed after he had made a substantive "determination" on the objections. The Authority's role was to determine the correctness of the objections and the Authority would "only interrupt that course in compelling circumstances in terms of my perception of fairness and justice, and the present situation does not seem to me to fall into that category" (paragraph [26]).

Judge Barber agreed with the Commissioner's submission that the decisions were final in the sense of determining the issues decided in them, but that that was insufficient to trigger a right of appeal under section 26 of the Taxation Review Authorities Act 1994 because that section only provided a right of appeal when a substantive determination had been issued. Judge Barber struck out the purported appeals.

QUESTIONS WE'VE BEEN ASKED

This section of the *TIB* sets out answers to some enquiries 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.

WHEN DOES DERIVATION OCCUR IN RELATION TO LAND SALES WITH A DEFERRED SETTLEMENT BY BUSINESS TAXPAYERS WHO PROVIDE VENDOR FINANCE?

Section CD 1, Income Tax Act 1994 – Land transactions

A taxpayer has asked when does derivation occur in relation to land sales with a deferred settlement by business taxpayers who provide vendor finance?

In the course of considering this question the item in *PIB No. 106 – July 1980 – Sale of Land on Extended Terms* was reviewed. The Commissioner no longer considers the statements in that item to be correct and it is formally withdrawn.

In relation to a sale of land, derivation generally occurs when a debt can be sued upon, which is usually also the time when the vendor loses their dispositive power. While this may be the same time as when the unconditional contract is signed, this will not always be the case. In considering the timing of derivation it is important to consider what gives the correct reflex of the taxpayer's income. For the majority of business taxpayers the accruals method of accounting, rather than the cash-receipts method, will be the most appropriate method to use. However there will be exceptions to this and the most important consideration is that the method of accounting used gives the correct reflex of the taxpayer's income.

Taxpayers should also consider whether the accrual rules apply when considering such sales where payment is deferred.

When are proceeds of land sales income?

Section CD 1 treats amounts as gross income where they are derived from the sale or other disposition of land:

> (1) Any amount derived from the sale or other disposition of land, being an amount to which this section applies, is gross income.

As section CD 1(1) sets out that income is derived when a sale of land takes place, it is necessary to establish what derivation is and when it occurs.

Generally what is derivation?

The generally accepted meaning of "derived" is as being something that is "obtained" or "got" or "acquired" as was discussed in *CIR v Farmers Trading Co Ltd* (1982) 5 NZTC 61, 200, and *FC of T v Clarke* (1927) 40 CLR 246, 261.

Derivation occurs when income "comes home" to the taxpayer. Generally the cash or receipts method (where income is returned in the income year in which it is actually or constructively received) is used by private individuals who are salary and wage earners and some professionals. The accruals or earnings method (where income is returned in the income year in which all events which determine the right to receive income have occurred) is usually used by most business taxpayers.

Commissioner of Taxes (SA) v Executor Trustee and Agency Co of South Australia Ltd (1938) 63 CLR 108 ("*Carden's case*") is an important case on derivation and is frequently referred to in subsequent decisions. The case sets out general principles of derivation which allow issues surrounding derivation in particular circumstances to be considered:

> Income, profits and gains are conceptions of the world of affairs and particularly of business. They are conceptions which cover an almost infinite variety of activities. It may be said that every recurrent accrual of advantages capable of expression in terms of money is susceptible of inclusion under these conceptions. No single formula could be devised which would effectually reduce to the just expression of a net money sum the annual result of every kind of pursuit or activity by which the members of a community seek livelihood or wealth. But in nearly every department of enterprise and employment the course of affairs and the practice of business have developed methods of estimating or computing in terms of money the result over an interval of time produced by the operations of business, by the work of the individual, or by the use of capital. The practice of these methods of computation and the general recognition of the principles upon which they proceed are responsible in a great measure for the conceptions of income, profit and gain, and therefore, may be said to enter into the determination of definition of the subject which the legislature has undertaken to tax. The courts have always regarded the ascertainment of income as governed by the principles recognised or followed in business or commerce, unless the legislature has itself made some specific provision affecting a particular matter or question. (p 152)

Dixon J did not consider it possible to state which method of accounting will be appropriate in each and every set of circumstances, and the following passage from his judgment provides a principle which has been referred to in numerous cases to establish which is the correct method of accounting to use in a particular circumstance:

> In the present case we are concerned with rival methods of accounting directed to the same purpose, namely, the purpose of ascertaining the true income. Unless in the statute itself some definite direction is discoverable, I think that the admissibility of the method which in fact has been pursued must depend upon its actual appropriateness**. In other words, the inquiry should be whether in the circumstances of the case it is calculated to give a substantially correct reflex of the taxpayer's true income**. [emphasis added] (p 154)

FC of T v Dunn 89 ATC 4141 and *FC of T v Firstenberg* 76 ATC 4141 also applied the principles espoused in *Carden's case*.

The cash or receipts method requires that income be returned for the income year in which it is actually received. In *CIR v The National Bank of New Zealand* (1976) 2 NZTC 61, 150 Cooke J (as he then was) observed that the cash method generally applies to most salary and wage earners, to private individuals who do not pursue a profession or business occupation, and to some professionals.

Generally, for business taxpayers, such as developers or real estate agents who provide finance for deferred property settlements, the method of accounting to be used is the accruals method. In *Carden's case* Dixon J commented about the accruals method:

> The foundation of the accruals system is the view that the accounts should show at once the liabilities incurred and the revenue earned, independently of the date when payment is made or becomes due. It is plainly not applicable to every pursuit by which income is earned. (p 157)

In *CIR v Farmers Trading Co Ltd* (1982) 5 NZTC 61, 200 ("*Farmers*") Pritchard J also commented on the accruals method of accounting:

> The essence of the accruals concept in this respect is that both revenue and costs are accrued (that is, recognised as they are earned or incurred not as money is received or paid), matched with one another so far as their relationship can be established or justifiably assumed, and dealt with in the profit and loss account of the period to which they relate; provided that where the accruals concept is inconsistent with the 'prudence' concept the latter prevails. (p 61, 210)

The Court of Appeal decisions of *CIR v The National Bank of New Zealand* (1976) 2 NZTC 61, 150 and *Fincon (Construction) Ltd v C of IR* [1970] NZLR 462 also considered that the accruals method is generally the most appropriate for business taxpayers.

While these cases set out the general principles of when the accruals method of accounting should be used, there are exceptions to the general rule that business taxpayers should use the accruals method of accounting.

FC of T v Dunn 89 ATC 4141 considered *D & GR Rankine v Commrs of IR* (1952) 32 T.C. 520 where it was concluded that the general rule was that the accruals method of accounting was the most appropriate for business taxpayers. However, it was also acknowledged that:

> There will sometimes be great practical difficulty in putting a value upon credit items at a time when they are only future or contingent or perhaps conjectural, and a like difficulty may even arise in connexion with bad or doubtful debts – all of which necessitate suspense accounts and troublesome readjustments and reopening of accounts when credits or debits mature or become ascertainable in amount … In all such cases no objection has been taken or could be taken to the common sense practical expedient of discarding the earnings basis in favour of the cash basis as the method of computation affording in the circumstances the best practicable approximation to the desired result. (p 4149)

In *J Rowe & Son Pty Ltd v FC of T* 124 CLR 421 it was also acknowledged that the accruals method will not be the most appropriate method for all business taxpayer's:

> I do not doubt that in some cases money payable at a future date ought to be left out of account until it is received or perhaps until it falls due. (p 438)

In each case the important question to ask, as propounded in *Carden's case* and others, is which method will give the most true and accurate reflex of the taxpayers income?

In relation to land sales by business taxpayers who provide vendor finance, where payment is deferred, when does derivation occur?

Derivation generally occurs when there is a right to sue upon a debt. This will commonly, but not always, be when the vendor loses their dispositive power over the land. In relation to the timing of derivation it is important to consider what will give the correct reflex of the taxpayer's income. For some sales of land the timing of derivation and settlement will be the same, but for others settlement and derivation may occur at different times. While this item is concerned with the sale of land it should be noted that the general principles of derivation are the same for land, goods and services. Just as there may be exceptions to the general rule that business taxpayers should use the accrual method of accounting, if it does not give the correct reflex of the taxpayer's income, there can also be exceptions to the general rule that derivation occurs when there is a right to sue upon a debt if this does not give the correct reflex of the taxpayer's income.

The right to receive income

The need for there to be a right to receive income in order for the income to be "derived" was referred to by Barwick CJ in *Henderson v FCT* 70 ATC 4016 ("*Henderson*"):

> When the service is so far performed that according to the agreement of the parties or in default thereof, according to the general law, a fee or fees have been earned and it or they will become income derived in the period of time in which it or they have become recoverable. But until that time has arrived, there is, in my opinion, no basis when determining the income derived in a period for estimating the value of the services so far performed but for which payment cannot be properly demanded and treating that value as part of the earnings of the professional practice up to that time and as part of the income derived in that period. (p 4020)

His Honour emphasised the point that until there is a right to receive income, derivation cannot be said to have occurred. For most business taxpayers, once everything has been done that is required for there to be a right to receive income or recover a debt, income will be "derived". This is the essence of the accruals method of accounting.

Henderson has been discussed in the Full Federal Court decision of *Dormer v FC of T* (2002) ATC 5078. *Henderson* was distinguished on the basis that the accounting practice in *Henderson* did not involve a change of business, unlike the facts in *Dormer*, and therefore the general principles from *Henderson* are still considered to be good law.

General cases concerning derivation

FC of T v Australian Gas Light Co 83 ATC 4800 ("*Australian Gas Light*") discusses several tests which have been put forward by the courts to state when income is derived, but the court concluded:

> Helpful as these tests may be as signposts, each of them has been conceived in and applied to varied and contrasting circumstances. As signposts they indicate that invariably something more than provision of goods or services by the taxpayer is required. It is necessary to determine whether the consequence is that a debt has been created or whether the taxpayer is obliged to take further steps before becoming entitled to payment. (4,805)

The judgment in *Australian Gas Light* highlights the fact that there are no firm rules which can determine the time at which derivation will occur in any given transaction. Instead it acknowledges that when derivation occurs is generally determined by the time when a debt can be sued upon, which will be affected by the particular facts of the case. The case is significant as it acknowledges that if further steps are required before the taxpayer is entitled to sue for a debt after a "sale" has taken place, then derivation will only occur once those steps have been taken and the taxpayer is able to sue for the debt.

The frequently cited case of *Arthur Murray (NSW) Pty Ltd v C of T* 114 CLR 314 ("*Arthur Murray*"), which relates to the derivation of income from services is an example of an exception to the general rule that derivation occurs when there is a right to sue upon a debt. That case involved payment of tuition fees for dance lessons. Students paid in advance for a set number of lessons or a lifetime of lessons to be taken in a certain period. The taxpayer put these advanced fees into a separate account and only transferred the money for each lesson, once that lesson had been received. This was in the event that the tuition fees may need to be refunded if the lessons were not taken (even though there was no contractual obligation for the taxpayer to refund money, they had a practice of doing so). The court held that the fees were derived only when the money was transferred from the separate account to the taxpayer's general account.

Therefore in *Arthur Murray* derivation was held to take place not when a debt was due, but when the necessary steps had been completed for the taxpayer to have a right to receive payment, even though the taxpayer had already received the money. This gave a more correct reflex of the taxpayer's income as the taxpayer did not have the right to use the money until it had fulfilled its side of the agreement and provided the dance lessons.

A case to note which qualifies the general rules on the timing of derivation of income is *BHP Billiton Petroleum (Bass Strait) Pty Ltd & Anor v FC of T* (2002) ATC 5169. This case dealt with the situation when there is a bona fide dispute between the parties to a contract as to an amount owed.

Land sale cases concerning derivation

Cases that have specifically dealt with land sales adopt the same approach as the one taken in general cases concerning derivation. The Commissioner considers that the judgments in both *Gasparin v FCT* (1994) 94 ATC 4, 280 ("*Gasparin*") and *Ruddenklau v Charlesworth* [1925] NZLR 161 support the concept of derivation generally occurring when there is an enforceable debt (which is different from there being an ability to sue for specific performance) and that this is generally the same time as the vendor loses their dispositive power over the property.

Gasparin involved a taxpayer who was a builder and land developer involved in the subdivision of a piece of land into allotments. Settlement of the sales was subject to the "acceptance, deposit and registration of the plan of subdivision in the Land Titles Office on or before the 30th of July 1985". On or before 30th June contracts relating to nine of the allotments had been settled. The contracts relating to the remaining 64 allotments were settled in the following financial year. The taxpayer treated these 64 allotments as "closing stock on hand" for accounting and taxation purposes. The Commissioner disagreed and considered that because the sales had become unconditional on or before 30 July 1985, that the allotments had ceased to be trading stock and were actually "sales".

In *Gasparin,* von Doussa J held that income was derived from the sale of the allotments which comprised their trading stock at the time of settlement (not when the contract became unconditional), when a debt accrued due from the purchaser to the taxpayer. It was held that the time when the debt arose was the critical consideration.

It was also held that each allotment remained trading stock on hand until settlement – as that was the time under the contract when the vendor taxpayer lost all dispositive power and the contingency that the sale would not proceed to completion had disappeared.

After considering other Australian authorities, von Doussa J concluded:

> In my opinion it should be held that the joint venturers derived income from the sale of the allotments of land which comprise their trading sock not when the contracts became unconditional, but at settlement when a debt accrued due from each purchaser to the joint venturers. **The critical consideration is the time when the debt arose**. [emphasis added] (4288)

The judgment in *Gasparin* referred to the New Zealand case of *Ruddenklau v Charlesworth* with approval. In *Ruddenklau v Charlesworth,* a contract for the sale and purchase of 747 acres of land had been entered into between the vendor Ruddenklau and the purchaser Charlesworth. A deposit on the purchase price of £200 was required to be paid. Possession of the land was then to be taken by Charlesworth on 7 January 1919 when a further £200 was payable. There were then specific dates set out for specific amounts to complete the purchase price to be paid. The purchaser paid the initial £200, but did not make any further payments, but remained in possession until October 1923 when he abandoned the property. Charlesworth argued that while he was liable to pay interest on the unpaid balance of the purchase money up to 1 February 1923 (which was the date upon which the balance of the purchase price was to be paid according to the contract), he was not liable for any interest after that. Ruddenklau contended that until the contract was rescinded or completed the purchaser was liable to pay interest on the balance of the purchase price, so long as it remained unpaid.

In *Ruddenklau v Charlesworth* it was stated:

> As a general rule, on the failure or refusal of a purchaser to complete an executory contract for the purchase of land the vendor is not entitled to sue for the purchase money as a debt. He is entitled merely to sue for specific performance or for damages for the loss of his bargain. It is only when the contract has been completed by the execution and acceptance of a conveyance that unpaid purchase money may become a debt and can be recovered accordingly. (p 164)

The judgment also discussed situations where a debt may arise earlier than the time of settlement and conveyance:

> … a contrary intention is sufficiently shown in all cases in which by the express terms of the contract the purchase-money or any part thereof is made payable on a fixed day, not being the agreed day for the completion of the contract by conveyance. In all such cases the purchase-money or such part thereof becomes on the day so fixed for its payment, a debt immediately recoverable by the vendor irrespective of the question whether a conveyance has been executed and notwithstanding the fact that the purchaser may have repudiated his contract. (p164)

This suggests that in relation to the sale and purchase of land, derivation can occur at a time earlier than settlement when a debt arises before that point. This conclusion is reached on the specific facts of the case which provided for set amounts to be paid on particular days with settlement occurring at a later stage. The Commissioner does not consider that this decision means that derivation occurs when a deposit is made on the purchase price prior to settlement, but rather it occurs when the contract provides for several payments to be made prior to settlement, and the purchaser may already have possession of the land.

The New Zealand Court of Appeal in *Hawkes Bay Power Distributions Ltd v CIR* (1999) 19 NZTC 15,226 appeared to agree with the Australian decisions in *Australian Gas Light* and *Gasparin* that when derivation occurs (when a debt accrued due from the purchaser and could be recovered accordingly) will depend on the particular facts and circumstances of a case as well as the provisions of any contract involved. This confirms that the reasoning in *Gasparin* is not confined to the Australian situation alone, but is also authoritative law, applicable in New Zealand, on the timing of derivation.

Derivation in relation to deposits

The timing of derivation in relation to deposits does not differ from the general principles relating to the timing of derivation. Generally, the existence of a deposit will not affect the timing of derivation. In line with ordinary principles, derivation still occurs when the income has "come home" to the taxpayer and there is an ability to sue upon a debt, or a right to receive the money. Only when the contract, under which the deposit was made, is settled and can be sued upon, does derivation normally occur.

If, for example there was a situation similar to that of *Ruddenklau v Charlesworth* (referred to above) where the deposit was the first of several part-payments of stipulated amounts as provided for in the contract to be paid on set dates, then the timing of derivation will most likely be affected as there is a right to each part-payment and if the money is not paid, then there is a debt which can be sued upon.

Whether the deposit is refundable or not in the event of a contract not proceeding through to settlement will affect the timing of derivation. However this does not differ from the ordinary principles of derivation discussed earlier. If the deposit is to be retained regardless of whether the transaction is completed then it is income which has been derived. This does not mean that the whole of the purchase price is derived—just the amount of the deposit made at the time. If the transaction did proceed, then the balance of the purchase price is derived when the contract is settled and can be sued upon.

Are there any exceptions to the general rules about derivation?

The cases of *Harrison v John Cronk & Sons* [1936] 3 All ER 747 ("*Cronk*") and *Absalom v Talbot* [1944] 1 All ER 642 ("*Absalom*") could potentially be seen as providing an exception to the rule that the accruals method of accounting is generally the most appropriate for business taxpayers. However, the Commissioner considers that *Cronk* and *Absalom* do not deviate from the general principles of derivation. The cases do not disagree that generally, business taxpayers should return income on an accruals accounting basis, and as must be done in all cases, the particular circumstances and nature of the transactions were taken into account to give the correct reflex of the taxpayer's income. Rather, when the quite unusual facts and nature of the transactions in those cases were considered, the courts concluded that to apply the general principles would be inappropriate and the cash-receipts method of accounting was more appropriate. The decisions have limited application for future decisions unless very similar fact situations present themselves.

Cronk involved a taxpayer building company which built and sold houses to purchasers of small means. A building society advanced to purchasers the whole of the purchase money to be repaid with interest in equal monthly instalments. Only part of the purchase money was paid to Cronk with the remainder retained by the building society as security in the event of default by the purchaser.

Cronk appears to have been largely decided on its particular facts and the provisions of the contract that existed between the building society and the taxpayer. Lord Thankerton's judgment appears to accept the general principle that business taxpayers should generally return income on an accruals basis, but stated that in this instance it was not appropriate as the taxpayer was not going to receive payment for many years:

> I am unable to agree with the view of the Commissioners and of Findlay J. that the whole of the purchase price should be brought into the account as a trading receipt at the time of sale. (p 193)

In *Absalom,* the appellant taxpayer was a speculative builder who sold properties to purchasers of small means. The purchasers paid only a small deposit, with a building society advancing the greater part of the balance on first mortgage, and the taxpayer advanced the remainder of the balance on the security of a second mortgage under which the debt was repayable with interest by instalments over a long period of time.

In *Absalom*, Lord Atkin stated the general principle that business taxpayers use the accrual method of accounting:

> No one doubts that in ordinary commercial practice where goods are sold on terms of ordinary commercial credit, three or six months or even more, traders are in the habit of treating the debt so created as part of the profits of the year in which the debt is incurred. (p 215)

However on the facts of this case and after consideration of the particular circumstances of the taxpayer's business, Lord Atkin concluded:

> According to the Crown's contention it makes no difference whether the price of goods is to be paid forthwith or at the end of twenty years or by instalments over twenty years, and whether with interest or not, nor, apparently, is the possibility or probability of the debtor being unable to continue the payments over the whole period a matter to be taken into account. To my mind, to treat money to be paid in twenty years hence as producing a profit this year equal to money in fact paid this year is to produce a completely unreal conception of yearly profit, and I venture to think quite foreign to any commercial ideas on the subject. (p 215)

Lord Atkin's acknowledgement that the transaction in *Absalom* was an extraordinary one conforms with the leading authorities in the area of derivation, such as *Carden's case,* which emphasise that the nature of the business will be one factor which determines which method of accounting the taxpayer uses.

The principle taken from the majority judgments in *Absalom* is that concern was had over the high risk that the builder would not receive payment, due to the purchasers being of "limited means" and the long period over which payments were to be made—therefore making it unfair that they should have to return the income at one time. The case states that the accruals method is generally the most appropriate method of accounting for business taxpayers. However the nature and circumstances of the case (the high risk of non-repayment and the long period of time before receiving payment), meant that the accruals method of accounting was inappropriate.

Although the judgments in both *Cronk* and *Absalom* do not discuss the general principles of derivation at any great length, it is apparent the House of Lords did in reality apply the derivation principles to reach the conclusion as to which is the most appropriate method for the builder taxpayers in these cases.

It appears that it was a regular part of the business of the taxpayers in both *Cronk* and *Absalom* to sell properties to purchasers of limited financial means. Therefore, while the cases have unusual facts which do not entirely conform to the principles espoused in other cases, they do still fit within the framework.

The cases of *Farmers*, *National Bank*, *Gardner, Mountain and D'Ambrumenil Ltd v IRC* [1947] 1 All ER 650, 29 TC 69 discuss the House of Lords' decisions in *Cronk* and *Absalom*. These cases distinguished *Cronk* and *Absalom* on the basis that they were decided on the special facts of the cases and were not therefore able to be applied. However, they were not overruled or considered to be bad law.

Timeframes for payment do not determine when business taxpayers should use the cash-receipts method of accounting

It is inappropriate to stipulate a fixed period of time at which point it becomes suitable for business taxpayers to use a cash-receipts method rather than an accruals method of accounting. To do so would be contrary to the principles espoused in cases such as *Carden's case*, *Fincon*, and *Henderson*, that the particular nature and circumstances of the transaction involved will determine the correct method of accounting.

While the length of time before repayment of a debt in a transaction would be one factor to consider in reaching a conclusion on the most appropriate method of accounting, other factors such as the likelihood of repayment, the creditworthiness of the debtor and the ability to value the debt are also relevant in reaching a conclusion. The Commissioner therefore considers that an exception to the general rule which only takes one factor into consideration is inappropriate.

It appears from the background to the item in *PIB No. 106* that the two exceptions as to when derivation occurs for business taxpayers contained in the item (1.The agreement provides for a small deposit with the balance payable by instalments over a period greater than ten years, or 2. The vendor at the time of sale secures the unpaid consideration by a second mortgage which has a term greater than 10 years) were based on the cases of *Cronk* and *Absalom*. The 10-year period appears to have been developed from the periods of time contained in those two cases, and the fact that the court in *Fincon* had considered that payment being deferred for six years was not long enough to require the taxpayer to return their income on a cash basis rather than an accruals basis.

The Commissioner now considers that the adoption of an estimated timeframe of 10 years, taken from the cases of *Cronk* and *Absalom* does not reflect the fact that those cases were very fact-specific and it is unlikely that the House of Lords intended the timeframes thrown up by the facts of those cases to go on to form a general rule.

Taxpayers should take care to note that if a section within the Income Tax Act 1994 stipulates the timing of derivation for that particular section, this will override the general principles of derivation taken from case law.

The impact of the accrual rules

The Commissioner considers that it is also likely that the accrual rules have an impact on business taxpayers who provide vendor finance to purchasers on deferred property settlements. These rules were enacted subsequent to the publication of the item in *PIB No. 106*.

The sale and purchase of property (including land), where receipt of consideration is deferred comes within the section EH 22(1)(b) definition of "financial arrangement" which is the first requirement in deciding whether a transaction is subject to the accrual rules.

In addition, deferred sales by the taxpayers specified would not generally come within the definition of "excepted financial arrangement" in section EH 24(1), unless payment of the purchase price was deferred for a period of less than 93 days, as contained in the definition of "short-term agreement for the sale and purchase of property".

As it appears such a sale of land is a "financial arrangement", it will be necessary for taxpayers involved in these financial arrangements to use a spreading method over the period of the arrangement and calculate the base price adjustment when the financial arrangement comes to an end. A spreading method must generally be used (except where a party to the financial arrangement is a cash-basis person) to spread the return on the financial arrangement (the difference between income and expenditure which is deemed interest) over the term of the financial arrangement.

The base price adjustment is a kind of "wash-up" calculation to catch any amounts which have not been accounted for during the financial arrangement. In brief terms, the BPA formula in section EH 47 (consideration – income + expenditure + amount) requires the amount which is the lowest price the parties would have agreed on had the transaction not involved a deferred payment to be taken into account. Section EH 48 defines "consideration" and section EH 48(3) requires the "lowest price … the parties would have agreed on … if payment would have been required in full at the time the first right in the contracted property was transferred or the services provided for", to be taken into account under "consideration". Determination G17B provides the means to calculate the value that can be inserted into the BPA formula in these circumstances. Determination G17B has not been updated since the Division Two Accrual Rules were introduced. However section 90AA of the Tax Administration Act 1994 states that such determinations apply "in principle" until a new and relevant Determination is made by the Commissioner under section 90AC of the Tax Administration Act 1994.

Section EH 26(1) gives the accrual rules priority unless another section of the Income Tax Act 1994 expressly states otherwise. Section EH 26(3) means that the accruals impact needs to be taken into account where the consideration paid for any property is relevant under any non-accrual section of the Income Tax Act 1994, and the value of any property transferred will need to be determined in accordance with section EH 48(3) of the Act.

As noted earlier, the item in *PIB No. 106* was published prior to the enactment of the accrual rules, and so they were not taken into account when considering the appropriate approach in the area of sales where payment was deferred.

The reasons for withdrawing the item in PIB No. 106

The item in *PIB No. 106* provides that a sale of land takes place (and therefore derivation occurs) when there is an enforceable contract and gives the example of an unconditional agreement for sale and purchase, stating that there is an enforceable contract at the time the agreement is signed by both parties.

The item also provides the two exceptions which are discussed above.

The Commissioner considers that the item in *PIB No. 106* is inaccurate for the reasons elaborated on above and is therefore withdrawn.

Conclusion

The Commissioner considers that derivation occurs when a sale takes place and a debt arises which can be sued upon, and generally this will be the same time as the vendor loses their dispositive power. While a debt may arise at the time an unconditional contract is signed, this will not always be the case. When considering when derivation occurs it is important to consider what will give the correct reflex of the taxpayer's income.

The accruals method of accounting will generally be the most appropriate method for business taxpayers to use, and the cash-receipts method will generally be the method for private individuals who are salary and wage earners and some professionals. While these methods of accounting are generally appropriate for these two groups of taxpayers it is always important to consider and apply the method that gives the most true and accurate reflex of the taxpayer's income.

The accrual rules will generally need to be taken into account when considering sales where payment is deferred.

As a result of considering the question asked, the item in *PIB No. 106* was reviewed, and the Commissioner no longer considers the statement in that item to be correct and it is hereby formally withdrawn.

LIVESTOCK VALUATION – ELECTION OF METHOD

Section EL 2(5), Income Tax Act 1994 – information for written notices of election

We have been asked whether an election notice made under the livestock valuation regime to exit the Herd Scheme, which contains more than one proposed method of valuation in relation to a class of livestock within a type, is a valid election.

On the basis of the interpretation of the words in section EL 2(1) and section EL 2(5) in particular and the scheme and purpose of the livestock valuation regime (as reflected in the statutory scheme and pre-legislative material) the Commissioner considers that the livestock valuation regime permits one future method of valuation per class of livestock to be contained in an election notice to remove a type of livestock from the Herd Scheme.

The Commissioner considers that a valid election notice may state different valuation methods for different classes of livestock within a type (provided that the combination of methods used complies with section EL 2(2)), but a valid election notice may not state **more** than one valuation method for a particular class of livestock.

Legislation

Section EL 2(4) states that taxpayers wishing to exit the Herd Scheme must provide notification when filing their tax return for the income year two years prior to the year in which the scheme change is to occur. Section EL 2(1) is the initial provision providing for elections to be made and it also provides that taxpayers may elect another method when wishing to exit the Herd Scheme and that that method will apply until superseded by a further election. Sections EL 2(4) and EL 2(2)(d) mean that it is not possible to remove a class of livestock from the Herd Scheme unless **all** of the classes within the type to which that class belongs are also removed from the Herd Scheme. Section EL 2(5) provides the elements which must be contained in the notice.

Section EL 2(1) provides that:

> (1) Subject always to this section and sections EL 3 to EL 7 and FF 9,—
>
> (a) A taxpayer may elect which of the methods specified in sections EL 3 to EL 7 is to be used in any income year to value any specified livestock of the taxpayer other than livestock used in dealing operations; and
>
> (b) Except as provided in subsections (3) and (4), any such election shall be sufficiently notified to the Commissioner, and shall apply for an income year, by the mere fact of the relevant valuation method being used for the purposes of the taxpayer's return of income for the income year; and
>
> (c) Any election once made in accordance with this section and applying in respect of any income year shall continue to apply in all subsequent income years until superseded by a further election made in accordance with this section.

Section EL 2(5) provides that:

> Any written notice of election required to be furnished under this section shall—
>
> (a) State the income year in which the election is to first apply; and
>
> (b) State the type, class, or other description of livestock to which the election relates; and
>
> (c) State both the existing and the proposed valuation methods for the livestock to which the election relates; and
>
> (d) In the case of an election under section EL 6(1) to use a herd value ratio or recalculated herd value ratio, state—
>
> (i) The value assessed under section EL 6(3) of an average animal of the taxpayer of each class of livestock within the type to which the election relates; and
>
> (ii) The date on which the valuation of each such animal was made; and
>
> (iii) The name and address of the person who carried out the valuation; and
>
> (e) In the case of an election to use a bailed livestock option referred to in section EZ 4(1), specify which of the 2 options under that section the taxpayer is electing to use,—
>
> and, once the written notice of election is furnished to the Commissioner, the election shall be irrevocable in relation to its first year of application.

The following definitions from section OB 1 are also relevant to the interpretation of Sections EL 2(1) and EL 2(5):

> **"Class"**, in the definitions of "high-priced livestock" and "national average market value", and in Part EL and sections EZ 1 and EZ 4, in relation to specified livestock, means any of the categories of livestock listed in column 2 of Schedule 8; and, when used in relation to any particular type of livestock, means any of the categories so listed in relation to that particular type:
>
> **"Specified livestock"** means any animal that is, in relation to any of the types of livestock set out in column 1 of Schedule 8, an animal of that type; but does not include any animal that is high-priced livestock:
>
> **"Type"**, in the definitions of "class", "herd livestock", "herd value ratio", "high-priced livestock", and "specified livestock", and in Parts EL, EZ, and FF, in relation to specified livestock, means any general category of livestock listed in column 1 of Schedule 8:

Application of the legislation – the ordinary meaning of the words in section EL 2(1)

By virtue of the section OB 1 definitions (outlined previously) and Schedule 8 of the Income Tax Act, when the word "type" is used in relation to the livestock valuation regime, it refers to the variety of animal involved, eg dairy cattle or sheep. When the word "class" is used in relation to the livestock valuation regime, it refers to the sub-categories within the type of livestock, eg mixed-age -cows, rising one-year heifers, ewe hoggets, or ram and wether hoggets.

The phrase "**which** of the **methods** specified in section EL 3 to EL 7 **is** to be used to value **any specified livestock**" in section EL 2(1), refers to a single method of valuation, in relation to each class of livestock within the type of livestock which is subject to the election, which is chosen from a number of different methods available to be selected.

The *Shorter Oxford English Dictionary* defines "which" as:

> **Which:** 3. Used in asking the identity of a choice made from a definite (stated or implied) set of alternatives.

In ordinary usage when the word "is" is contrasted to "are", it refers to singular items. This is confirmed by the definitions of "is" and "are" in the *New Collins Concise English Dictionary*:

> **Is:** (used with he, she, it, and with <u>singular</u> nouns) a form of the present tense (indicative mood) or be.
>
> **Are:** the <u>plural</u> form of the present tense of **be** and the singular form used with *you*.

These definitions indicate that "is" is used when indicating a singular and "are" is used when indicating a plural. By contrasting these definitions, it is possible to conclude that had the word "are" been used in section EL 2(1), it would be acceptable to choose more than one valuation method per class of livestock. However the use of "is" in the subsection indicates that only one valuation method may be stated in relation to a class of livestock within the type of livestock to which the election relates.

In addition, the *Shorter Oxford English Dictionary* defines "is" as:

> **Is:** That which exists, that which is; the fact or quality of existence.

While it appears that the definition of "is" refers to the existence of something (in the sense of the present rather than the past tense), the use of the word "that" in the definition of "is", and everyday usage of "is", indicates that a singular item is intended by the definition:

- "that" is defined by the *Shorter Oxford English Dictionary* as:

  > **That:** 1. The thing or … person indicated, mentioned or understood.

- "that" refers to singular items in the present tense. If more than one item was to be referred to, a word such as "those", would be used.

The *Shorter Oxford English Dictionary* defines "methods" as:

> **Method:** 2. A mode of procedure; a (defined or systematic) way of doing a thing, esp. … in accordance with a particular theory or as associated with a particular person

The methods referred to in section EL 2(1) are the various types of ways in which livestock may be valued according to the livestock valuation regime.

When "which" and "is" are used in conjunction a single item is suggested. This is based on the grammar the section uses—if more than one item was permitted the words "which" and "are" would be used together.

Application of the legislation – the ordinary meaning of the words in section EL 2(5)

Section EL 2(5)(a) requires the notice furnished by the taxpayer to "state the type, class, or other description of livestock to which the election relates". As the election notice may describe livestock by type or class or other description, different valuation methods may be used for different classes within the type of livestock being removed from the Herd Scheme, provided that the combination of methods used complies with section EL 2(2).

The words "livestock to which the election relates" are important in interpreting the provision. As section EL 2(2)(d) requires that all animals within a type of livestock must be removed from the Herd Scheme when making such an election, the "livestock to which the election relates" are all of the classes of livestock within the type which is to exit the Herd Scheme. It is not required that all animals within the type of livestock being removed from the Herd Scheme are moved to the same future valuation method.

The words used in section EL 2(5)(c) "state both the existing and the proposed valuation methods for the livestock to which the election relates" also require interpretation.

The use of the plural "method**s**" in section EL 2(5)(c) requires two methods to be stated: **one** existing method and **one** proposed method. The plural does not attach to just the proposed method, allowing more than one to be stated, and to read the subsection in this way ignores the importance of the final sentence of the subsection.

The section uses the words "both … methods". The *Shorter Oxford English Dictionary* gives the meaning of "both":

> **Both:** Adj. The one and the other; the two (and not just one)
>
> **Both:** Pron. 1. The one and the other (and not just one)
>
> 2. Each, the two, of (two persons, things, etc)

These definitions support the view that "both" the existing method and proposed method of valuation are required to be stated in the notice of election. The word "both" in its ordinary meaning is used to refer to two items, not more than two items.

While an argument could be made that the word "**methods**" supports the view that a farmer providing a notice to the Commissioner could state more than one future method of valuation in an "either/or" format this argument is not considered to be a strong one. That interpretation would be more arguable if the subsection was worded: "state the existing and the proposed valuation methods for the livestock …", however the use of the word "both" makes the above interpretation more difficult to sustain.

The final words of section EL 2(5) which state "once the written notice of election is furnished to the Commissioner, the election shall be irrevocable in relation to its first year of application" are also important in concluding that a single method of valuation is required.

The *Shorter Oxford English Dictionary* defines "election" as the making of a choice. "Choice" is defined as "choosing or deciding between possibilities". Consequently, when a farmer makes an election, a decision as to which particular future valuation method to use **must** be made; it is not acceptable for **more** than one future valuation method to be stated for a class of livestock.

Also, the word "irrevocable" used in the final words of the subsection colours the interpretation of the whole of subsection (5).

The *Shorter Oxford English Dictionary* defines "irrevocable" as:

> **Irrevocable:** 1. Unable to be recalled or recovered
>
> 2. Unable to be annulled or undone; unaltered, irreversible.

The Commissioner considers that on the plain meaning of the provision the **whole** of the election notice furnished is required to be irrevocable (as opposed to the subsection just requiring either the exiting of the Herd Scheme to be irrevocable or the proposed method to be irrevocable) as it states "**the election** shall be irrevocable". The election includes the livestock to which the election relates, and the existing method and the future method of valuation for each class of livestock—these factors make up the entire election, which will be "irrevocable in relation to the first year of application". This means that for the year after the election takes effect (ie the year after the change in methods actually occurs) the election to remove the type of livestock from the Herd Scheme cannot be changed and the proposed valuation methods selected for each class of livestock within that type cannot be changed.

It is not acceptable for an "either/or" type of election to be made in relation to a class of livestock. Such an election is not "irrevocable", as a choice is still to be made at a later stage as to which future method of valuation will be used to value that particular class, making the election uncertain. The fact that the election itself is stated to be irrevocable could also be seen as inconsistent with being able to make an "either/or" type of election. By making an "either/or" type of election, the election would not ordinarily be described as irrevocable as there is no certainty as to which method has actually been selected for that class. In order for the election to be "irrevocable" it seems more intuitive that a definite choice of valuation methods must be made.

The purpose of the livestock valuation regime

Although strong arguments can be made on the words of section EL 2(1) and section EL 2(5) that a singular method of valuation is to be selected, it is useful to examine the purpose or the legislative intent of the livestock valuation regime to discern the meaning of the provisions. The pre-legislative material eg *The Discussion Paper on Livestock Valuation* dated December 1991, *The Report of the Consultative Committee on Livestock*, 2 September 1992, and relevant material in *Hansard* supports the view that only one "proposed" method of valuation per class of livestock may be contained in an election notice.

New Zealand Income Tax Law and Practice (CCH) provides a general description of the Herd Scheme:

> Essentially the herd scheme treats livestock as a capital asset so that any upward or downward movement in herd values between income years is treated as a capital gain or loss, and is not assessable or deductible for tax purposes … Thus, an important point with the herd scheme is that changes in herd values between years are not taxable. Taxable income or deductible losses arise only to the extent of changes in the numbers of herd livestock.

The *Report of the Consultative Committee on Livestock Valuation*, 2 September 1992 also describes the Herd Scheme:

> The herd scheme is intended to reflect the fact that in some respects a herd or flock can be likened to a "machine". The "machine" is a relatively fixed asset, owned and maintained for the sale value of what it produces, rather than for its own inherent sales value. The

> herd scheme exempts from tax any inflationary gains on the realisation of the "machine" over and above its "cost", but rather than permitting annual depreciation, the scheme gives tax deductions for the annual cost of "repairs and maintenance" i.e. the difference between the value of replacement animals and the proceeds from the sale of the stock replaced.

The livestock valuation regime (including the Herd Scheme) was enacted to ensure that farmers were treated in the same manner as other business taxpayers. While it is acknowledged that the Herd Scheme was seen as largely concessionary, as it allows farmers to treat their herd of animals as a capital asset, restrictions were also imposed upon the exit from the scheme so that farmers were encouraged to choose a scheme which reflected long-term business needs, rather than simply for tax purposes.

The *Discussion Paper on Livestock Valuation* commented on the notice period required in order to exit the Herd Scheme:

> This restriction encourages farmers to choose a scheme which reflects the nature of their long-term business needs, rather than simply for tax purposes.

The requirement that farmers choose which method of valuation they plan to use for each class of livestock within a type two years into the future was designed to put some "risk" into any decision to exit the Herd Scheme. The "risk" involved having to predict the market values of the livestock two years in advance.

Conclusion

Accordingly, on the basis of the interpretation of the words in section EL 2(1) and section EL 2(5) in particular, and the scheme and purpose of the livestock valuation regime (as reflected in the statutory scheme and pre-legislative material) the Commissioner considers that the livestock valuation regime permits only one future method of valuation for each class of livestock to be contained in an election notice for a type of livestock to exit the Herd Scheme.

The Commissioner considers that a valid election notice may state different valuation methods for different classes of livestock within a type (provided that the combination of methods used complies with section EL 2(2)), but a valid election notice may not state **more** than one valuation method for a particular class of livestock.

LIVESTOCK VALUATION – PREVIOUS YEARS' INVALID ELECTIONS

We have been asked what would happen to elections for livestock valuation in previous years, which have been confirmed as invalid. This question has again arisen following the finalisation of a recent statement on the method of election for livestock valuation *(Livestock Valuation – Election of Method)*, as published in this edition of the *Tax Information Bulletin.* We have also been asked what the Commissioner would do in respect of invalid elections where taxpayers have already filed their income tax returns.

Application of the legislation

Section EL 2(5) of the Income Tax Act 1994 provides that a taxpayer electing to exit the Herd Scheme must also specify a proposed valuation method in order to make a valid election.

Where an invalid election has been made, section EL 2(8) requires the Commissioner to make a determination of the correct method after consulting with the taxpayer.

What happens to previous years' invalid elections?

As confirmed by the QWBA on *Livestock valuation – Election of method*, the following elections to exit the Herd Scheme are invalid:

- Taxpayer filed an election that states they will adopt **either** national standard cost **or** market value/replacement cost for all classes of livestock within a type, or
- Taxpayer filed an election to exit the Herd Scheme but failed to state any proposed valuation method(s).

Inland Revenue practice

It is not considered practical, nor an efficient use of resources (of the Commissioner and of the taxpayers) to make large-scale enquiries of taxpayers, for back years, to ascertain whether invalid elections have been made. Under these circumstances, the Commissioner will determine the valuation method to be applied by a taxpayer as that method actually used by the taxpayer, providing the method used is a valid option available to the taxpayer at the time the election notice was filed. Inland Revenue will not accept further requests to change the valid valuation method used in the income tax return.

Where a taxpayer has not yet filed their income tax return, they may seek agreement from the Commissioner to use a different valuation method, providing the method used is a valid option available to the taxpayer at the time the election notice was filed.

NEW LEGISLATION

INCOME TAX ACT 2004

To assist readers of this article, new and redefined terms that are fundamental to the operation of the rewritten legislation are presented in *italics* in the text. This is intended to help readers distinguish the new or redefined term from similar terms in the Income Tax Act 1994 (the 1994 Act).

Introduction

The Income Tax Act 2004, which received Royal assent on 7 May 2004, represents the third stage in the rewrite of income tax legislation, using plain language techniques.

It rewrites Parts C to E and Part Y of the 1994 Act and makes consequential amendments to Parts A, B and F to O. Rewriting these provisions is not intended to change the effect of the law, with the exception of the policy changes referred to in schedule 22A.

The rewritten Parts C to E contain:

- An exhaustive list of provisions that state the circumstances in which a transaction or other event gives rise to *income* (Part C).
- An exhaustive list of general and specific provisions that interact to state the circumstances in which a person has a *deduction* for an expenditure or loss (including a loss in value) arising from a transaction or event (Part D).
- A list of provisions and regimes that modify the general timing rules of derived (for *income*) and incurred (for expenditure or a loss) and, in a number of cases, quantify that timed amount (Part E).

Application

The Income Tax Act 2004 applies from the first day of the 2005–2006 *tax year* or the first day of the *corresponding income year* of a person who has a tax balance date other than 31 March.

Background

History of the rewrite

New Zealand's income tax legislation dates back to 1891. In the intervening period, the legislation has significantly expanded the concept of income to keep pace with the changing nature of income-earning activities in New Zealand.

Income tax legislation was recast on several occasions during the twentieth century. However, not until the 1990s was it comprehensively reviewed from a structural and presentational perspective.

Since 1990, various bodies and officials have prepared reports and papers that discussed rewriting the income tax legislation, including:

- The Consultative Committee on the Taxation of Income from Capital (the "Valabh Committee").
- The Working Party on the Reorganisation of the Income Tax Act 1976.
- The Organisational Review of the Inland Revenue Department.
- Government discussion papers.
- Issues papers prepared by government officials.

In its final report in 1990, the Valabh Committee highlighted various weaknesses in the numbering, formatting and reorganisation of the legislation. They included:

- The failure of the core provisions to integrate with each other and with the rest of the Act.
- The difficulty of discerning the scheme and purpose of the legislation.
- The lack of logic in both the structure of the legislation and the ordering of its sections.
- The lack of organisation of the legislation and its failure to reflect adequately the legislation's role of quantifying taxable income, imposing a tax liability on that income and setting out a process of assessment and collection of that liability.
- The inconsistent drafting style and the presence of redundant wording, cumbersome sections and repetitive provisions.

The report led to the re-ordering and renumbering of the Income Tax Act 1976, the subsequent enactment of the 1994 Act, the Tax Administration Act 1994 and the Taxation (Core Provisions) Act 1996 (the Core Provisions Act). As a result, the 1994 Act organised the legislation into parts that were structured around a set of core provisions using an alphanumeric numbering system. There was some consolidation of material by topic, and the definitions were brought together in one section.

Objective

The primary aim of rewriting the Income Tax Act is to produce legislation that clearly and unambiguously states the policy. This objective is regarded as integral to reducing compliance and administrative costs and increasing voluntary compliance with the tax law.

Consultation

During the drafting of the 2004 Act, and in line with New Zealand's generic tax policy process, extensive consultation occurred with specialists within and outside the Inland Revenue Department. The Institute of Chartered Accountants of New Zealand and the New Zealand Law Society also made a significant contribution to the drafting process.

This consultation occurred at several points during the drafting of this Act:

- During the development of the exposure draft, released in September 2001.
- Between the release of the exposure draft and the introduction of the "rewrite bill", the Income Tax Bill 2002, introduced in November 2002.
- During submissions and consideration of the bill by the Finance and Expenditure Committee.
- After the report back of the bill by the select committee but before its second reading.

This process was undertaken to provide assurance for the taxpaying community that the rewritten legislation had been subject to an extensive and rigorous examination to minimise the possibility of unintended policy changes being included in the 2004 Act.

Erroneous interpretations of provisions in the 1994 Act

Taxpayers should, however, pay particular attention to the comments of the select committee in its commentary in reporting back the Income Tax Bill 2002. In particular, the committee noted that there is a:

> … risk that some practitioners, having previously misinterpreted some provisions in the old Act, may fail to realise that the rewrite Act clarifies the correct interpretation that applies to those provisions, and continue to apply their erroneous interpretation to the new Act. Such a situation should be minimised as far as possible, and we therefore encourage the Inland Revenue Department to undertake an education programme to inform practitioners that they cannot necessarily rely on their current understanding of the law, and should actively check the provisions contained in the new Act.

This statement makes it clear that Parliament intends that readers are to discern the meaning of a provision of the 2004 Act using the normal rules of interpretation. That Act contains transitional provisions that require the 1994 Act to be used as an interpretive guide, but only in some limited circumstances.

The future

The remainder of the 2004 Act is to be rewritten progressively. The projected timetable is for the rewrite of income tax legislation to be completed during 2007.

KEY FEATURES

Application

The 2004 Act applies from the first day of the 2005–2006 *tax year*, being, at the earliest, 2 October 2004 for early balance dates.

The deferral of the application date from that originally proposed, the 2004–2005 *tax year*, gives taxpayers, advisers and Inland Revenue time to familiarise themselves with the new legislation.

Transition

The 2004 Act is not intended to contain any changes in policy, unless such a change is signalled in schedule 22A.

The 2004 Act is to have full force from the time of its commencement. This means that taxpayers will not need to refer to the provisions of the 1994 Act unless either of the following two situations arise:

- A provision in the 2004 Act is unclear or leads to an absurdity. In this situation, section YA 3(4) ensures that the 1994 Act (and associated case law) is to be used as the key authoritative interpretive guide.
- A clearly stated provision in the 2004 Act is compared with the corresponding provision and the 1994 Act to determine if that provision contains an unintended policy change. In this situation, a non-legislative process is to be established to review the factual situation raised and, if necessary, to recommend remedial retrospective legislative change to the government. This process will be administered by the Rewrite Advisory Panel, headed by the Rt Hon Sir Ivor Richardson, former President of the Court of Appeal.

Core provisions

The core provisions in Parts A and B contain some new concepts that are intended to better reflect the scheme and structure of the rewritten Act.

Overall, there is little structural change to the core provisions. Their purpose continues to be to impose a variety of tax obligations and to set out rules for calculating and satisfying those obligations.

Core concepts

The core concepts for the calculation of taxable income for a *tax year* are *annual gross income* and *annual total deduction*. These core concepts are located in sections BC 2 and BC 3 respectively.

The concept of *annual gross income* contains two elements, assessable *income* and timing. The defined term *annual total deduction* also contains two elements, *deduction* and timing. These elements are defined in subpart BD and are more fully discussed later in this article.

The concept *annual total deduction* replaces the defined term *annual allowable deduction* in the 1994 Act.

Income, deduction and timing

The concept of "gross income" in section BD 1 of the 1994 Act had different meanings in subsections (1) and (2). These different meanings have been separated and relabelled in the 2004 Act as:

- *Income* (corresponding to former section BD 1(1).
- *Assessable income* (corresponding to former section BD 1(2)).

Section BD 1 of the 2004 Act defines *income* by pointing to Part C, which contains an exhaustive list of provisions that state whether or not an amount constitutes *income*. An amount of *income* is timed to a *tax year* under either a general (derivation) or a specific timing rule.

The concept of "allowable deduction" in the 1994 Act has been replaced by the term *deduction*. This term is defined in section BD 2 by pointing to Part D, which contains an exhaustive list of what qualifies as a *deduction*. In the same manner as *income*, a *deduction* is timed to a *tax year* under either a general rule (when incurred) or a specific timing rule.

Non-residents' foreign-sourced income

This is a new defined term. The relationship of this term with the concepts of *income* and *assessable income* establishes the scope of the New Zealand income tax base. It achieves this by ensuring that this category of *income* is not included in calculating taxable income for a *tax year.*

The rule was previously signposted by section AA 2 and contained in section BD 1(2)(c) of the 1994 Act.

Omissions and relocations

Sections AA 2 and AA 3(1) of the 1994 Act have been omitted.

Subsections BD 2(1) and (2) of the 1994 Act, relating to the concept of a *deduction*, have been relocated to subpart DA of the 2004 Act.

Income

Exhaustive list

An amount arising from a transaction or an event is *income* only if a provision in Part C describes it as *income*.

Dividend rules

The dividend rules are presented around a single core rule "transfer of value" from a company to a person in that person's shareholder capacity.

This new presentation has been reviewed in detail by private sector tax specialists to ensure that the effect of the law remains unchanged.

Deductions

Exhaustive list

An amount of expenditure or loss or calculated amount is a *deduction* if Part D describes that amount as a *deduction*. The *deduction* rules are presented around a single core rule, *the general permission*, and a set of *general limitations*. The *general limitations* were the provisions set out in section BD 2(2) of the 1994 Act.

The relationship between a specific *deduction* provision and both *the general permission* and *general limitations* are explicitly stated in the final subsection of the specific provision.

Depreciation rules

The depreciation rules have been rewritten to harmonise with *the general permission*. This is because the operation of section EG 2(1)(e) of the 1994 Act provided a test of deductibility for depreciation very similar to *the general permission*.

Again, these rewritten rules have been reviewed in detail by private sector tax specialists to ensure that the effect of the law remains unchanged.

Timing and quantification

Part E contains provisions that modify the core timing rules of "derived" and "incurred" and in some cases also quantify the amount that is timed.

A provision in Part C or Part D may continue to state the timing of an amount of *income* or a *deduction*, if the timing element is closely linked to the provision.

Policy changes

All intended changes in policy are listed in schedule 22A and typically involve clarifications of existing policy.

Provisions in the 1994 Act that have also become unnecessary or obsolete have been omitted from the rewritten Act. Schedule 23 identifies these omissions, many of which were located in the "Z" subparts of Parts C, D and E of the 1994 Act.

Drafting approach

The drafting of the rewritten Act uses structure, drafting style and features of the Interpretation Act 1999 to provide clarity.

All of Parts C, D and E are organised by the generality of application to taxpayers. The most generally applicable provisions are located closer to the front of each part. A similar approach has been adopted within each subpart.

Sections have been drafted to address a single concept. This has meant that many sections of the 1994 Act have been broken up into a number of sections. The main operative rule is located at the start of each section. Other subsections within that section are drafted to supplement that main operative rule.

Impact on other legislation

The 2004 Act clarifies the standard approach to the repeal of an income tax Act.

The 2004 Act repeals the 1994 Act, but only in respect of tax on income derived in the 2005–2006 and later *tax years* (sections A 2(2) and YA 1(2)). Sections YB 5(1), (2) and (3) have not been repeated in the 2004 Act, as these 1994 provisions simply confirmed that the repeal of the 1976 Act applied only to the tax on income of future years.

The 2004 Act also makes consequential amendments to the Tax Administration Act 1994 (schedule 22) and many other Acts of Parliament (schedule 21).

Existing binding rulings and accrual determinations have been saved, provided the ruling or determination relates to a tax law in the 1994 Act that has a corresponding provision in the 2004 Act. Schedule 22A lists those provisions in the 2004 Act that contain intended policy changes.

PARTS A AND B

Introduction

The short title and commencement provisions located before Part A and the core provisions in Parts A and B have some consequential but minor changes to accommodate the structure employed in Parts C, D, and E. There are also changes in some key terms.

The overall operation of the core provisions is not altered by the 2004 Act. However, under the 2004 Act, a working knowledge of the core provisions and their relationships to the rewritten provisions in Parts C, D, and E is fundamental to understanding:

- the scheme and purpose of the Act, and
- the way in which Parts C, D, and E have been rewritten to support the operation of the core provisions.

Two key purpose provisions in the rewritten Act are sections AA 1 and BA 1.

- Section AA 1 states the general purpose of the 2004 Act is to define and impose tax on net income. To support that purpose, the Act sets out definitions, obligations, and rules for calculating and satisfying the obligations.
- Section BA 1 identifies that the purpose of Part B is to impose tax on net income. Part B imposes obligations concerning tax and sets out rules for calculating and paying the tax imposed.

Changes in core provisions

Main changes

Section AA 2

Section AA 2 has been omitted on the basis that it serves no particular purpose and did not accurately reflect the scope of the 1994 Act. The provision was considered to serve only to point to the concept of source and residence and the related obligations for non-residents that were embedded in the exclusions of a "foreign-sourced amount" from "gross income" in section BD 1(2)(c) of the 1994 Act.

Section AA 3

Section AA 3(1) has been omitted on the basis that it is addressed in the Interpretation Act 1999.

Part B

The core rules relating to *income* are contained in Part C, and section BD 1(1) of the 2004 Act points the reader to those provisions. The core *deduction* rules and the general prohibitions against deductibility, formerly found in section BD 2 of the 1994 Act, are now located in subpart DA. Section BD 1 of the 2004 Act points to these provisions in subpart DA.

They are presentational changes that clarify the role of Parts C and D. The changes reaffirm the original intention that these two Parts are intended to be exhaustive in determining whether an amount is *income* (Part C) or a *deduction* (Part D).

Until the Act is completely rewritten, however, there will continue to be some *income* and *deduction* provisions located in Parts F through to I. This is both signposted and addressed in subparts CY and DY, to ensure that Parts C and D are exhaustive in their coverage.

Changes to key concepts

Some key terms used in the core provisions either replace defined terms in the 1994 Act, or are used to simplify drafting, as shown in Table 1.[1]

Table 1: Comparison of key concepts

2004 Act	1994 Act Corresponding term
Annual gross income[2]	Annual gross income
Annual total deduction	Annual allowable deduction
Income [3]	Gross income under section BD 1(1)
Assessable income[4]	Gross income under section BD 1(2)
Excluded income	Not defined but explained in section BD 1(2)(b)
Non-residents' foreign sourced income	Not defined but explained in section BD 1(2)(c)
The general permission	Section BD 2(1)(b)(i) and (ii)
General limitations	Section BD 2(2)
Depreciation loss	Amount on account of depreciation (EG 1(1))
Income year/ corresponding income year	Income year to which section OF 2 applies and non-standard accounting year
Tax year	Income year

Initial provisions

Section A 2(2) contains an important transitional provision relating to the commencement of the 2004 Act. This rule is reinforced by the "repeal provisions" in section YA 1(2).

The effect of section YA 1(2) is that the 1994 Act is repealed only in relation to the tax on *income* in the 2005–2006 and later *tax years* or *corresponding income years*. However, *the 1994 Act* continues to have full effect for *tax years* and *corresponding income years* before the 2005–2006 *tax year*.

[1] As noted, these terms are italicised throughout the article.
[2] Term now refers to "assessable income". Previously it referred to "gross income".
[3] **Before** taking into account exempt income and other exclusions referred to in BD 1(2).
[4] **After** taking into account exempt income and other exclusions as referred to in BD 1(2)

Part A

Section AA 1 sets out the broad purposes of the 2004 Act. They are to define and impose tax on net income, to impose obligations concerning tax and to set out rules for the calculation and satisfaction of those obligations.

Section AA 2 reinforces the legislative principles of the Interpretation Act by highlighting how readers' aids to interpretation are to be used.

Under section AA 3(1), references to "this Act" continue to include a reference to the Tax Administration Act 1994, but only in the Parts of the 2004 Act yet to be rewritten and Parts O and Y. Once those Parts are rewritten, section AA 3(1) of the 2004 Act will be repealed.

Part B

There has been no change in the global/gross scheme and structure introduced by the Core Provisions Act. However, the relationship of each of Parts C to E to the core provisions is more clearly identified.

Subpart BA

Section BA 1 states that the overall purpose of the core provisions is to establish:

- A statutory scheme for the calculation and satisfaction of taxation obligations, and
- The structural relationships that exist within the core provisions and between the core provisions and the rest of the 2004 Act.

Subpart BB

Subpart BB sets out the obligations that the 2004 Act requires a person to satisfy. Each or all of these obligations may be modified by the general anti-avoidance rule (section BG 1) and New Zealand's obligations under a double tax agreement (section BH 1).

The obligations listed in section BB 2 are:

- The calculation and satisfaction of the income tax liability for each tax year (section BB 2(1) and subpart BC).
- The calculation and payment of provisional tax for a tax year (section BB 2(3) and the provisional tax rules).
- The calculation and satisfaction of withholding liabilities (section BB 2(4) and subpart BE).
- The calculation and satisfaction of a variety of other taxes (section BB 2(5) and subpart BF).

The rest of Part B and the remainder of the Act set out the concepts and procedures that are followed to calculate and satisfy these obligations. The relationships within Part B and between Part B and the rest of the 2004 Act are described in the following paragraphs.

Subpart BC

Sections BB 1 and BB 2 are linked to subpart BC, which provides the detailed process that must be followed to meet the obligation to calculate and pay income tax for a *tax year*. Under subpart BC, a person's income tax liability is defined as the arithmetic result of this process.

Unless the person is a non-filing taxpayer, this process contains a series of steps, involving the calculation of net income, taxable income, and the income tax liability for a *tax year*. A non-filing taxpayer's income tax liability for a *tax year* is, in general, determined by taxes deducted at source (if any).

In order to apply subpart BC (the calculation of the income tax liability for a *tax year*), a person must understand the core concepts of *annual gross income* and *annual total deduction*.

These core concepts are defined in sections BC 2 and BC 3 respectively. A further new concept introduced at this stage is *corresponding income year*, which ensures that the core provisions align the calculation of the income tax liability for a *tax year* to the tax balance date of the taxpayer. The tax balance date may be either the standard date (31 March) or an early or late balance date. The consistent use of the terms *tax year* and *income year* in the rewritten Act has meant that subsections (1) and (2) of section OF 2 of the 1994 Act could be omitted from the 2004 Act.

Annual gross income for a *tax year* is a global concept. Section BC 2 of the 2004 Act defines it as the aggregate of all *assessable income* from all sources that is derived in or allocated to the *corresponding income year*. The concepts of *assessable income* and allocation are explained further in subpart BD.

Annual total deduction for a *tax year* is also a global concept, and section BC 3 of the 2004 Act defines it as the aggregate of all *deductions* that are incurred in or allocated to the *corresponding income year*. The concept of *deduction* is explained further in subpart BD, as is the concept of *allocation*.

Subpart BD

Subpart BD has an important role to supplement the operation of subpart BC, as it explains the core concepts of *assessable income*, *deduction,* and *allocation*. It also defines the extent of New Zealand's income tax base.

Assessable income

The concept of *assessable income* is defined in section BD 1 as the amount of *income* left after excluding any part of that *income* that comprises *exempt income*, *excluded income,* or *non residents' foreign-sourced income*.

An amount of *assessable income* may be spread or allocated across more than one *tax year*.

To understand this concept, the reader also needs to understand the meaning of *income*, *exempt income*, *excluded income,* and *non-residents' foreign-sourced income*.

Income

The concept of *income* is described in section BD 1. This definition is supported by all of the provisions in Part C through the explicit linkage in section BD 1(1). That section identifies that Part C is a code in relation to its role of determining whether an amount arising from a transaction or event is *income*.

Gains and profits that are not treated as *income* under Part C are not subject to income tax. Examples of this category are capital profits and windfall gains.

The only exclusions from *income* are found in subsections BD 1(2) (*exempt income*), (3) (*excluded income*), and (4) (*non-residents' foreign-sourced income*). These subsections represent a series of exclusions from what is *income* under section BD 1(1).

After applying these restrictions, the amount (or apportioned amount) that arises from a transaction is termed *assessable income*. *Assessable income* under section BD 1(5) represents the amount of *income* that is included in the determination of a person's income tax liability for a *tax year*, subject to any allocation of that *income* between different *tax years*. This amount may be allocated across more than one *tax year*.

Exempt income

The category of *exempt income* (section BD 1(2)) is reserved for amounts of *income* that Parliament determines should not be subject to income tax.

> An example of exempt income is found in section CW 34 of the 2004 Act, which exempts the non-business income of charities.

Excluded income

Falling within the concept of *excluded income* (section BD 1(3)) are amounts of *income* that are not included in income because they are generally subject to tax in another way.

> For example, life insurance premiums derived by a life insurer (and reinsurers) are excluded income (section CX 33 of the 2004 Act). The exclusion arises because the life insurance rules in subpart EY separate the income (underwriting) and savings elements of those premiums and include the underwriting elements in income.

Non-residents' foreign-sourced income

This category of *income* establishes the role that the source of *income* and a person's residence play in determining whether an amount of *income* is subject to taxation in New Zealand (section BD 1(4)). It also enables New Zealand to identify what *deductions* a non-resident may or may not be entitled to.

Source and residence

The concepts of source and residence are fundamental to determining the scope of New Zealand's income tax base. This is achieved through the overall operation of section BD 1.

Section BD 1(1) defines the subject matter of the 2004 Act by reference to the amounts listed as income in Part C. As explained later in this article, the concept of *income* under Part C does not depend on the concepts of time, residence or source.

Section BD 1(5) provides that the concept of *assessable income* does not include *income* derived by a non-resident that is not treated as being derived from New Zealand at the time that person is non-resident. The overall effect of section BD 1(1) gives the following outcomes:

- *Income* that a resident of New Zealand derives from anywhere in the world is *assessable income*, provided that *income* is neither *exempt* nor *excluded income* (section BD 1(2) or (3)).
- *Income* that a non-resident derives from New Zealand is *assessable income*, provided that *income* is neither *exempt* nor *excluded income* (section BD 1(2) or (3).
- *Income* that a non-resident derives from sources outside New Zealand falls within *non-residents' foreign-sourced income* and is not *assessable income (section BD 1(4))*.

Allocation of income (timing)

Section BD 3 explains the basis on which the legislation allocates *income* to a particular *income year*. In this context, the term *income year* has been chosen because allocation applies to both the standard (31 March) and non-standard tax balance dates.

The general rule is that the Act allocates *income* to an *income year* on the basis of when it was derived, or credited in the account of a person or dealt with in the interest or on behalf of the person. Common law principles are also to be taken into account when considering the sometimes divergent tax accounting results that arise between business and cash basis taxpayers (section BD 3(3)).

It is important to note that the allocation process is of the *income*, not just the *assessable income*. Therefore the method of allocating an amount of *income* applies also to any part of that *income* that is *exempt income*, *excluded income*, *non residents' foreign-sourced income* and *assessable income*. Allocation of the *income* on a consistent basis for all categories of income is necessary because of the nexus tests under *the general permission* which link deductibility with *assessable income* (section DA 1).

For example, an amount of income derived by a non-resident may be apportioned between non-residents' foreign-sourced income and assessable income. The allocation of both the non-residents' foreign-sourced income and assessable income across income years will be proportionate to how the income is apportioned.

Assuming that deductions in deriving income are allowed under the general permission, this allocation of income can be expected to influence the amount of deduction allowed in each tax year.

The general rule may be overridden by any rule that allocates the *income* on another basis, but only if that rule is located in Parts C or E to I. This reflects the fact that parts F to I are still to be rewritten.

Deduction

Sections BD 2 and BD 4 explain the core concept of *deduction* and the timing of a *deduction*.

The concept of *deduction* in section BD 2 is a key link or signpost between the core provisions in subpart BC and the operative rules found in subpart DA (previously located in section BD 2 of the 1994 Act). This relocation reflects the intention of the reorganisation of income tax legislation that all *deductions* should be grouped within one Part of the Act.[5]

Section BD 2 identifies that Part D is a code for determining whether an amount arising from a transaction or event is a *deduction*. This means that a person may not have a deduction unless it is listed in Part D. Where a *deduction* is allowed under a Part yet to be rewritten, the matter is addressed by section DY 1 of the 2004 Act.

For example, section HF 1(2) Profits of mutual associations in respect of transactions with members.

Allocation of deduction (timing)

Section BD 4 provides that a *deduction* is always allocated to an *income year*. Again, the term *income year* is used here to signal the application of the allocation provisions to persons with non-standard tax balance dates.

The general rule is that a deduction is allocated to an *income year* on the basis of when it was incurred. Again, common law principles must be taken into account when considering any possible divergent treatment that exists in tax accounting as between business and cash basis taxpayers.

[5] The reorganisation of the Income Tax Act 1976 resulted in the enactment of the 1994 Act.

This general rule of allocation may be overridden by any rule that allocates the *deduction* on another basis. That rule applies to *deductions* located in Parts D to I, which also reflects the point that Parts F to I are still to be rewritten.

Other obligations

Provisional tax

Section BB 2(3) imposes the obligation to pay provisional tax. It also points to the details of the provisional tax rules, which set out the process for calculating and paying provisional tax.

Withholding liabilities

Sections BB 2(4) and BE 1 continue to provide the obligation to comply with various tax payment systems, such as PAYE, resident withholding tax, non-resident withholding tax, fringe benefit tax, specified superannuation withholding tax and dividend withholding payments.

Section BE 1 also provides a link to the detailed provisions that a person needs to know in order to be able to comply with these obligations.

Miscellaneous obligations

Again, there is no change to section BF 1, which imposes an obligation to pay various taxes:

- Qualifying company election tax on entry into the qualifying company rules.
- Income tax on taxable distributions made from non-qualifying trusts.
- Withdrawal tax on special farm ownership, home ownership and fishing vessel ownership savings accounts.
- Further income tax for debit balances at the imputation year end in imputation credit accounts.
- Further dividend withholding payments for debit balances at the imputation year end in dividend withholding payment accounts

PARTS C, D AND E

Introduction

The structure of the revised Act has been the subject of much discussion from the time of the Valabh Committee's final report, issued in 1990. The September 1997 government discussion document, *Rewriting the Income Tax Act: Parts C, D and E*, set out a detailed structure for these three Parts.

The importance of Parts C, D and E as a group is that, together, they provide the details that enable taxpayers to calculate their income tax liability for a *tax year*, as required by the core provisions. The discussion document recognised that creating a clearer scheme for the Act requires a logical organisation of the material that takes into account both the function of provisions and their subject matter. Therefore improving the structure has been a key aim of the rewrite project.

The core provisions enacted in 1996 gave the Act a more consistent scheme, establishing the notion that each part of the Act has a specific function. The 2004 Act reinforces this concept across Parts C, D and E and also clarifies the interaction of those parts with the core provisions.

General structural principles

The general structural principles used have been:

Organising from the general to the specific

Parts, subparts and sections generally begin with more widely used rules and conclude with less widely used rules.

Using general rules to perform a pivotal role

General rules are used to overarch more specific rules. The *general permission* in section DA 1 is a prime example. This approach helps to identify the inter-relationships between the provisions and any common policy intent.

Minimising overlap

An aim has been to make the categories used as self-contained as possible. This is largely achieved by limiting the subject matter of each section to a single concept.

Grouping like with like

Provisions performing similar functions or having similar subject matter have been grouped to provide the reader with the relevant context.

Reducing repetition

An aim has been to minimise duplication. Applying common sets of rules is one technique that has been used to achieve this.

Using a consistent format

This aids accessibility by improving the flow of the text.

Providing a link back to the core provisions

Subpart A (in both Parts C and D) sets out general rules that link back to the core provisions. Subpart A of Part E contains some commonly used timing rules. Purpose provisions are not used in any of these three rewritten Parts on the basis that the title, structure, index and subindexes should adequately clarify the role of the Part.[6]

[6] When the Act was restructured in 1994, subparts CA, DA and EA were reserved for provisions setting out the purpose of the relevant part (as recommended by the *Second Report of the Working Party on the Reorganisation of the Income Tax Act 1976*, page 16).

Part E does not have a set of general rules that link back to the core provisions. This was not possible because Part E contains a disparate set of timing and quantification rules and provisions.

Placing terminating provisions into a separate subpart at the end of each part

This is a continuation from the 1994 Act, but the contents of subparts CZ, DZ and EZ have been significantly culled because many of the provisions were either spent or were unlikely to have future relevance. Deleting these provisions does not remove their application to relevant past situations. The omitted provisions can be identified by referring to Schedule 23 of the 2004 Act.

Relationship to core provisions

Overall, the core provisions retain their role of stating the principal rules on what *income* is, what a *deduction* is and how that *income* or *deduction* is timed. Parts C, D and E then provide the associated detail.

Net rules

As signalled in the discussion document on Parts C, D, and E and the exposure draft of the rewritten Act, it has not been feasible to put the rules for some areas on a gross basis. Those areas in the 1994 Act are the financial arrangement rules (subpart EH), the international rules (controlled foreign companies and foreign investment funds–subpart CG) and the life insurance rules (subpart CM).

These are specialist, self-contained areas that produce a net amount that is either *income* or a *deduction*. Hence, even though these groups of rules have not been rewritten on a gross basis, the calculation of the amount treated as *income* or a *deduction* still fits within the general scheme of the rewritten Act.

PART C

Introduction

The functions of Part C are to:

- provide an exhaustive list of what is *income* for income tax purposes
- identify the taxpayer to whom the *income* belongs
- provide a catchall provision in section CA 1(2) to pick up any amounts outside these other categories that would be income under ordinary concepts
- define amounts that would be *income* but may, nevertheless, be exempted or excluded from *income*.

If an amount arising from a transaction is not *income* under Part C, that amount does not fall within the scope of the 2004 Act. An example would be a capital gain arising from the sale of a private residence that does not fall within the land sales rules in subpart CB. This is illustrated in the diagram outlining the process of calculating and satisfying income tax liabilities set out in subpart BC.

A key principle introduced in the Core Provisions Act is that under Part C, *income* is a global or gross concept that does not depend on the concepts of time, source or residence. However, a specific provision in Part C may take into account the concepts of source or residence as a parameter in determining whether an amount is *income*.

> An example in the 2004 Act where residence is relevant to the determination of income is found in section CQ 2(1)(d) (attributed controlled foreign company income).

General structure

The structure of Part C gives greater prominence to the provisions having the widest application. For example, *income* from business or trade-like activities, *income* from ownership of property and dividends are the subject matter of the first three subparts of Part C.

There are four general groupings of *income* under the structure:

- *Income* from business or trade-like activities.
- *Income* from holding property (divided into 2 subparts—economic rentals and returns on equity investments).
- *Income* from employment or contractor activity.
- Government entitlements (such as pensions and grants).

There is generally no overlap between these categories, although it will continue to be possible for an amount to be income under a specific provision as well as under section CB 1 (Gains made from a business). This is the case under the 1994 Act, and no difficulty is envisaged in retaining this overlap as it does not impinge on whether an amount is income.

> For example, a royalty is income under section CC 9, but the royalty may also be a gain derived by a business.

An amount of *exempt* or *excluded income* may be subject to another form of tax obligation imposed under section BB 2. Generally, the specific provision signals the linkage to the relevant tax obligation.

> For example, section CW 9(2) states that the dividend withholding payment rules apply to this exempt dividend. This gives a clear signal that despite the exempt nature of the dividend, there remains a tax obligation in respect of the exempt dividend.

Dividends

The dividend rules have been restructured around a core rule based on the concept of value passing from a company to its shareholders. This core rule was implicit in section CF 2 of the 1994 Act. In presenting the dividend rules around this core rule, no change in law is intended.

Because of the presentational changes, there has been extensive consultation with private sector tax specialists to ensure that the outcome of the rewritten law matches the provisions in the 1994 Act.

Background

The dividend provisions contained in subpart CF of the 1994 Act had varied history.

Before 1958, dividends were not taxed directly. From 1958 to 1988, the general tax position was that both the company and the shareholder were taxed, with no recognition of any tax paid by the company when an amount was distributed.

In 1988 the imputation system was introduced. It allows individual dividend recipients to receive a tax credit for any New Zealand tax paid by the company on profits that gave rise to the dividend.

Also in 1988, the definition of "dividend" in the Act was rewritten because it had become unwieldy, not only as a result of incorporating imputation but also through the introduction of various withholding tax rules, fringe benefit tax, and a range of policy amendments. Those policy amendments essentially widened the definition to bring in non-cash items.[7]

In the early 1990s, the Valabh Committee reviewed the definition of "dividend", and several changes were made as a result. The key change was the introduction of an explicit shareholder capacity test. It limited the definition's coverage to distributions arising from a shareholder's ownership interest in a company.[8] Since then, the main change to the definition has been to provide for the tax consequences of company law reform that facilitated the buy-back of shares.

Case law

Key cases underlying the law on dividends are *Smout v CIR* (1982) 5 NZTC 61,158 and *CIR v Brierley* (1990) 12 NZTC 7,184. These cases found the definition of "dividend" was a complete code for the primary tax consequences of transactions between a company and its shareholders.

A code attempts to embody everything (including the common law and existing statutes) in a coherent piece of legislation. The presumption behind these two cases was that distributions from a company to a shareholder that were not dividends were capital in nature and were, therefore, not taxable elsewhere within the Act. Legislative changes since these two cases intentionally limited their effect.

> For example, under section CF 2(15) of the 1994 Act, a share repurchase can give rise to gross income when the shares are held on revenue account, despite the fact that amount is excluded from being a dividend. Other exceptions are found in sections CF 3(1)(g) and (h) (1994 Act) which, respectively, relate to fringe benefits and certain monetary remuneration received by shareholders. Although these two items are not dividends, they are not free of tax consequences.

Approach underlying the rewritten dividend provisions

The central idea behind the definition of "dividend" is that it should include all distributions from a company to its shareholders.

With the objective being to achieve a simpler and clearer set of rules, the starting point for the rewritten definition is that a "dividend" is any net transfer of value from a company to a person that is obtained by virtue of a shareholder's ownership interest in a company. This underlies the concept of "transfer of value" in the 2004 Act.

There are certain limitations to this wide coverage because not all transfers of value are treated as dividends in the 1994 Act. As a result, two types of adjustments become necessary:

- Some additions to the rules are necessary to prevent such transfers of value being treated as dividends in the 2004 Act.
- Some items are mentioned in the legislation to remove doubt as to whether they are dividends.

Overall, no change has been made to the effect of the dividend rules. Presentational changes are summarised in Table 2 on page 56.

[7] For example, the remission of loans to shareholders, the acquisition of property at above market rates from shareholders, the making available of company property for the private use of shareholders and the provision of low-interest loans to shareholders, and shares in lieu of dividends.

[8] A person may receive a payment from a company in many possible capacities—for example, as an employee (in the form of wages), or payment for the provision of other services (say, as a contractor), or from the sale of an asset to the company. From the perspective of a dividend, what is important is that there is a link between the payment and a person's shareholding in the company.

Table 2: Presentational changes in the dividend rules

Type of adjustments	Reason for adjustment
Additions	
Imputation and DWP credits	Not of value to company but are of value to shareholder
Certain foreign tax and refunds of foreign tax	Are a benefit to the credits recipient but not paid by the company
Attributed repatriation by controlled foreign company	Is notional non-cash adjustment and so no transfer is made by the company
Taxable bonus issue	No transfer of value as there is no distribution of property
Certain non-cash benefits of shareholder-employees	Is a transfer of value but not necessarily received in shareholder capacity
Subtractions	
Returns of capital share cancellations, treasury stock and so on	Are transfers of value but no net gain to shareholder
Capital distributions on liquidation	Are transfers of value but are capital rather than income in nature
Taxed elsewhere: – to FBT – monetary remuneration, – cash distributions in relation to notional distributions, – FIF interest calculated under certain methods	Ensures no double subject taxation
Property from amalgamating company that does not exist after the amalgamation	Is conceptually not a transfer of value as the company remains in existence as part of the amalgamated company
Property made available by flat-owning company	No real transfer of value as is merely a form of ownership
Use of associated company's property	De minimis rule applies. Exclusion for "downward" transfers are only caught because of breadth of "associated person" rules
Included to remove doubt	
Non-taxable bonus issues	No transfer of value as no property distributed. Share splits reduce the value of existing shares. Included in legislation to confirm that they are excluded *income.*

Benefits of this approach

The main benefits of generically defining the concept of "dividend" and then making specific adjustments to that general rule are:

- Readers are able to tell at an early stage whether they need to delve further into the subpart.
- It focuses on the essence of a dividend, which is a net transfer of value from the company to the shareholder in the capacity of shareholder.
- It simplifies the presentation by removing the need to list all possible instances when a distribution is a dividend. The concept of "transfer of value" covers all of section CF 2(1)(a)-(k) of the 1994 Act (apart from "taxable bonus issues" in (f)).
- It facilitates the drafting for future policy changes relating to dividends as such changes can more readily be accommodated through the adjustments.

Specific drafting style

The approach used in the 2004 Act for the dividend rules differs from that of the 1994 Act in at least two main areas.

- The terms "company", "share" and "shareholder" have been rationalised and redefined. The aim is to have a consistent set of words defining when non-standard entities, such as unit trusts, category A group investment funds and producer boards are treated as companies. Although this stretches the natural meaning of the terms "company" and "share", it is necessary to use a single, defined term that is meaningful to readers, as the relevant entities are generally "bodies corporate" in nature.
- The various explanations and qualifications that relate to the individual adjustments to the general rule are now located with the adjustments. Detailed calculation rules are dealt with subsequently and separately.

Comparison with 1994 Act

The 1994 Act distinguishes between what is a dividend (section CF 2(1)) and what is not a dividend (section CF 3(1)).

Following each of these subsections is a series of provisions found both in the rest of subpart CF and elsewhere within the 1994 Act. Under the 1994 Act, readers had to work their way through these provisions to establish whether there were any limitations to any item specified in either section CF 2 (1) or section CF 3 (1) or how to calculate the amount that is, or is not (as the case may be), a dividend.

In the 2004 Act, these additional rules are located either alongside their relevant lead provision or within a separate segment containing detailed calculation rules (to avoid obscuring the basic rules).

To assist readers, complex and inter-linked definitions have generally been converted into sections located in the relevant segment of subpart CD of the 2004 Act. At present, key definitions are spread between subpart CF and section OB 1 of the 1994 Act. The definition most affected by this is "available subscribed capital".

Reordering of employee remuneration and benefits provisions

Amounts that employees are required to account for as *income* are brought together in subpart CE. This includes amounts currently included in the definition of "monetary remuneration" and benefits under share purchase agreements.

Amounts that employees would ordinarily be required to account for as *income*, but which are specifically exempted, have been brought together in an "employee or contractor income" division of subpart CW (Exempt income) of the 2004 Act.

Fringe benefits are identified in a "fringe benefit" division of subpart CX (Excluded income) of the 2004 Act. However, the rules governing the calculations of the value of the benefit, the taxable benefit and ultimately the fringe benefit tax payable are located in subpart ND of the 2004 Act.

Recoveries

Income can also arise under provisions located in subpart CG. This subpart brings together the separate provisions throughout the Act relating to recoveries and adjustments for the purposes of:

- Negating the effect of a *deduction* previously allocated to an *income year*, such as in the case of a recovered bad debt. Some of these provisions are referred to in Schedule 22A, as the timing of the adjustment in these cases no longer has retrospective effect.
- Limiting the effect of a *deduction* in the *income year* to which it is allocated, such as trading stock adjustments for stock on hand at year end or when a government grant or suspensory loan is provided to fund the expenditure giving rise to the *deduction*.

Specific groups of rules

In addition, there are a number of specific groups of rules that give rise to *income*:

- The provisions relating to controlled foreign companies and foreign investment funds, life insurance, superannuation funds, petroleum mining and mineral mining are respectively contained in subparts CQ, CR, CS, CT, and CU. As the key operational provisions relating to these areas quantify and time the amount that is treated as *income* or a *deduction*, these provisions are located in Part E.
- Entity-specific rules for group companies, primary producer cooperatives and crown research institutes are contained in subpart CV.

Exempt and excluded income

Amounts that are *exempt income* or *excluded income* are, respectively, specified in subparts CW and CX.

Exempt income covers amounts that would normally be considered to be *income* but are exempted by virtue of the nature of the *income* or by various characteristics of the person who receives the *income*.

Excluded income covers those other amounts that the statute excludes from *income* because they are generally subject to tax in another way, such as a life insurance premium derived by a life insurer (section CX 33 of the 2004 Act). The amount of *income* derived from a life insurance premium is determined under the life insurance rules.

Another example of *excluded income* is all fringe benefits. These benefits are treated as being equivalent to *income* or would be treated as *income* were it not for the fact that someone else pays the tax.

Subparts CY and CZ

Subpart Y notes that there are provisions in the parts of the Act yet to be rewritten that make items *income*. Pending the rewrite of Parts F to N of the 2004 Act, section CY 1 provides the link to any provision in a Part yet to be rewritten that treats an amount as *income* and ensures that Part C is a complete code in relation to defining *income.*

> For example, section FF 7 of the 2004 Act provides for income to arise when a right to take timber is transferred under a matrimonial agreement. The amount of income is equal to the amount treated as consideration under section FF 7. Section CY 1 states that amount is income.

Similarly, Part D contains a comparable subpart (DY) for *deductions* elsewhere in the Act. The location of the provisions outside Parts C and D will be reviewed as the other Parts of the Act are progressively rewritten, with the intention that eventually all *income* or *deduction* provisions will be contained in Parts C and D respectively.

Subpart Z has been retained for terminating provisions.

PART D

Introduction

The purpose of Part D is to provide a legislative code of when an amount is a *deduction*. The legislation has a general deductibility rule, *the general permission*, which is set out in section DA 1. The rules in section BD 2(2) (1994 Act) have also been rewritten in section DA 2 as *general limitations* to *the general permission*. Section DA 3 sets out the legislative relationship between the specific rules and the general rules.

Specific *deduction* provisions are contained within subparts DB to DF and DN to DX. These subparts cover a range of supplementary *deductions*, specific entity rules, and limitations to *the general permission*.

The rules are not grouped according to whether they supplement or limit *the general permission*. Instead, the approach adopted favours a subject-based approach that gives taxpayers an assurance that, once they have dealt with the provisions in a discrete block, there are unlikely to be other provisions elsewhere that also need to be taken into account.

Nevertheless, the drafting still needs to identify which rules have priority, to reduce the need to revert to finding established common law principles. Hence, each section that allows a *deduction* concludes with a provision identifying its relationship with *the general permission* and the *general limitations*.

The general permission

Part D establishes a general overarching rule that allows a *deduction* for expenditure or loss that satisfies the nexus requirements of the general deductibility rule in section DA 1.

This general deductibility rule, termed *the general permission*, is an amalgam of section BD 2(1)(b)(i) and (ii) of the 1994 Act. It also explicitly reaffirms the implied position under the 1994 Act that a person has a *deduction* for an expenditure or loss incurred in deriving *excluded income*. This relationship is also clarified in the business test.

These provisions allow a *deduction* for an expenditure or loss incurred by a person (including a *depreciation loss*):

- in deriving *assessable income*, *excluded income* or a combination of the two
- in the course of carrying on a business for the purpose of deriving *assessable income*, *excluded income* or a combination of the two.

The priority of this rule in the overall scheme of income tax legislation has been established by the courts. Therefore it is appropriate for the rewritten Act to make the law more accessible to readers by identifying the approach adopted by the courts in determining how the general and specific *deduction* provisions interact with each other. For example, Richardson J in *CIR v Banks*,[9] held that:

> The statute provides a code in relation to deductibility. Section 110 prohibits the deduction of any expenditure or loss except as expressly provided in the Act. The general authority for deductions in calculating assessable income is contained in s 111 *[the general permission of the 2004 Act*]. . . . The next step is to consider the application of the specific provisions of s 112 [*the general limitations of the 2004 Act*] and subsequent deduction provisions, either modifying in particular classes of cases the right to a deduction which would otherwise exist under s 111, or authorising deductions not allowable under that section.

Rationalisation of rules having the same effect as the general permission

A key objective in the rewrite is to rationalise rules that have similar effect. Particular attention has been given to rules having a similar effect to *the general permission.*

Prime examples of this in the 1994 Act are the interest deductibility rule (section DD 1(b)(i) and (ii)) and the deductibility for an amount of depreciation (combined effect of sections EG 1 and EG 2). The effect of both of these rules is similar to the general deductibility rule in section BD 2 of the 1994 Act. In the rewritten Act, *the general permission* is intended to achieve the same outcome as these specific rules.

General limitations

There are six *general limitations*. Each generally overrides *the general permission*.

The policy underlying a specific *deduction* provision, however, may be to override a *general limitation*. If this is the case, this relationship between the specific *deduction* provision and the relevant *general limitation* is explicitly stated in the rewritten legislation in the final subsection of the relevant provision, headed "Link with subpart DA". The effect of these "relationship subsections" is confirmed by section DA 3, which codifies the effect of judicial interpretation on the relationship between the *general limitations* and specific *deductions* over a long period of time.

[9] [1978] 2 NZLR 472; (1978) 3 NZTC 61,236; (1978) 2 TRNZ 323

For example, in *Waste Management NZ Ltd v CIR*, [10] Richardson J stated:

> The expenditures in the present case are capital but that is not a bar to their deductibility if they satisfy the express criteria of section 124 [*of the Income Tax Act 1976*].

To provide greater clarity in the law, section DB 37(5) of the 2004 Act codifies that particular finding by the courts. Therefore there is no need for the reader to go to the common law to establish the relationship between this specific provision and the *capital limitation*.

As a result, the 2004 Act reflects the judicial approach to interpreting the 1994 Act. This simplifies access to the law, rather than leaving the reader having to revert to searching the common law to find the judicially determined relationships.

Capital limitation (DA 2(1))

Section DA 2(1) is a re-enactment of section BD 2(2)(e) of the 1994 Act. Any implicit override of this limitation is now addressed within each relevant specific deduction provision. This approach clearly identifies the policy rationale for that specific provision as allowing a *deduction* for capital expenditure.

Private limitation (DA 2(2))

Section DA 2(2) rewrites section BD 2(2)(a) of the 1994 Act. The latter rule has almost unlimited application throughout the 1994 Act, and the courts have consistently held that expenditure of a private or domestic nature is not allowed as a *deduction* unless Parliament expressly allows a deduction for private expenditure.

This principle has been carried through into the rewritten legislation, although there are some exceptions.

For example, in section DB 3 of the 2004 Act, the private limitation is overridden for expenditure a person incurs in determining specific tax liabilities.

Exempt income limitation (DA 2(3))

If any *income* is treated as *exempt income*, it follows that any expenditure incurred in deriving that *income* is not deductible.

Section DA 2(3), however, does not apply to deny a *deduction* for expenditure incurred in deriving amounts that are either not *income*, or are *excluded income*. For any expenditure within this category to be a deduction, it must satisfy either *the general permission* or a specific *deduction* and not be subject to any of the other *general limitations*.

[10] (1995) 17 NZTC 12,147

For example, in CIR v Brierley,[11] the Court of Appeal considered whether a deduction was allowed for interest incurred on funds borrowed to buy shares. These shares produced both taxable and non-taxable (but not exempt) income. The Court of Appeal held that no apportionment was necessary and therefore the exempt limitation could not apply:

> … the distributions were not 'income' within the meaning of section 106(1)(k). Not being income, they could not have been exempted from a liability which never existed.

Employment limitation (DA 2(4))

Section DA 2(4) rewrites section BD 2(2)(c).

Withholding tax limitation (DA 2(5))

Section DA 2(5) rewrites section BD 2(2)(d).

Non-residents' foreign-sourced income limitation (DA 2(6))

Section DA 2(6) is a new and explicit presentation of existing law and policy.

The provision states explicitly what was embedded in the interaction of sections BD 1(2)(c) and BD 2(1)(b)(i) and (ii) of the 1994 Act.

Under the 1994 Act, a foreign-sourced amount derived by a non-resident was not "gross income" under section BD 1(2)(c). Therefore expenditure or a loss incurred by a non-resident in deriving a foreign-sourced amount could not be an "allowable deduction" because it did not meet the nexus tests of deductibility. This non-deductibility of an expenditure or loss is clearer under the new drafting.

Relationship between the general permission, specific deductions and the general limitations

Position under the 1994 Act

The Income Tax Act 1994 does not explicitly state how specific provisions and the general rules are intended to interact. This has led to considerable uncertainty and a significant amount of litigation on this issue over a number of years.

To reduce compliance costs, the rewritten legislation incorporates the relationships between the specific deductions and *the general permission* and *general limitations*, as reflected in judicial interpretation.

General deductibility rule and specific deductions

A key structural feature implicit in the scheme of the 1994 Act (and the 1976 Act) is the relationship between the general deduction provision and specific deduction provisions.

[11] (1990) 12 NZTC 7,183, 7,188; 14 TRNZ 713

The courts have held that the general deductibility rule is always the first point in determining whether an expenditure or loss is a deduction. If the transaction in question does not give rise to a deduction under the general deductibility rule, it is only then that the specific provisions are examined.[12]

These decisions identify that specific deductions are viewed generally by the courts as:

- Restricting the right to a deduction under the general rule.
- Authorising a deduction that would not otherwise be available. [13]

General prohibition against deductibility and deductions

Section BD 2(2) in the 1994 Act states that an amount of expenditure or loss is not an allowable deduction to the extent it falls within the categories listed in paragraphs (a) to (f).

The effect of section BD 2(2) is to prohibit generally any deduction for an expenditure or loss even if it would have been allowed as a deduction under section BD 2(1)(b)(i) and (ii). The courts have, over the years, been required to examine the relationship of specific deduction provisions, the general deduction rule and the general prohibitions.

For example, from Hill v CIR[14] it is clear that some specific deduction provisions permit a deduction for capital expenditure (this is recognised in section BD 2(2)(e)), despite that expenditure or loss not being allowed as a deduction under section BD 2(1)(b)(i) or (ii). In this case Richardson J held:

> And in policy terms it is readily understandable that Parliament should distinguish between revenue and other specific deductions allowable in the years in which they are incurred and a set off of the capital cost of timber as and when it is sold.

Position under the 2004 Act

Section DA 3 in the 2004 Act is a new provision, but does not introduce new law.

It codifies the effect of the judicial decisions on the scheme of income tax legislation as it relates to the relationship between the specific deductions and the general deductibility rule and the general prohibitions against deductibility.

The principle behind the approach in section DA 3 is for the rewritten Act to state explicitly whether a specific rule:

- narrows or expands *the general permission*
- overrides or does not override the *general limitations*.

General permission and specific deductions

Section DA 3 signals an overall approach that each specific *deduction* provision which has the effect of narrowing or expanding on *the general permission* must identify whether it:

- Overrides *the general permission*, in which case the specific provision is modifying *the general permission* by providing a limit to or a prohibition against the *deduction*—for example, section DD 1 (Entertainment expenditure).
- Allows a *deduction* that would not be available under the *general permission*, in which case the provision "supplements" the *general permission*—for example, section DB 7 (Interest). Most companies need no nexus with income.

General limitations and specific deductions

An amount that would otherwise be a *deduction* is not deductible if a *general* (or specific) *limitation* applies. Again, this codifies the effect of decisions of the courts relating to the scheme for *deductions*.[15]

The non-deductibility of an expenditure or loss having a private or domestic nature is an example of a general limitation (section DA 2(2)). The non-deductibility of bad debts, unless they are written off (section DB 23(1)), is an example of a specific limitation.

A specific *deduction* may override a *general limitation*, such as with a *depreciation loss*. The effect of section DA 3 requires each such override to be explicitly stated. In this way, the rewritten Act ensures that it is clear that the relevant *deduction* is allowed, even though the underlying expenditure or loss breaches the relevant *general limitation*. The subsection that provides for any "Link with subpart DA" also clarifies whether or not *the general permission* must be satisfied also and whether the other *general limitations* apply.

Section DA 4 is a special provision that clarifies at an early stage the relationship between the *deduction* allowed for a *depreciation loss* and the *capital limitation*.

Subject-based approach to Part D

Following the decision to group the specific *deduction* provisions according to subject matter, subparts DB to DF cover specific subject matter. Each subpart is

[12] *Richardson J in CIR v Banks [1978] 2 NZLR 472; (1978) 3 NZTC 61,236; (1978) 2 TRNZ 323* – see footnote 11 and related text.

[13] CIR v Brierley [1990] 3 NZLR 303; (1990) 12 NZTC 7,184; 14 TRNZ 713 – "That statutory approach suggests that the Legislature viewed the positive deduction provisions of s 106 as independent of section 104. There is too the further consideration noted earlier that in some cases the deductions contemplated under section 106 would not be available if section 104 also had to be satisfied. Paragraph (h) itself is an extreme example. It would be extraordinary if, in a paragraph containing no reference to section 104, subpara (ii) provided an independent self-contained test of deductibility of interest while subpara (i) of the same paragraph was subject to section 104."

[14] (1994) 16 NZTC 11,037; (1994) 18 TRNZ 522

[15] *CIR v Mitsubishi Motors NZ Ltd* [PC] [1995] 3 NZLR 513; [1996] AC 315; (1995) 17 NZTC 12,351; 20 TRNZ 89, Lord Hoffman said: "In addition, … there is section 106, which prohibits the deduction of various enumerated items of expenditure even if they come within section 104."

arranged to list the rules from the more commonly applicable provisions to the less commonly applicable.

Subparts DN to DV list *deduction* rules for specific groups.

Subpart DY notes that there are provisions in other parts of the Act that make items a *deduction*, and subpart Z covers terminating provisions.

Employee and contractor expenditure

The specific *deduction* provisions for employers in subpart DF of the 1994 Act now appear in subpart DC (Employee and contractor expenditure) of the 2004 Act. Each provision's relationship to *the general permission* has been made clearer.

The rules limiting *deductions* for expenditure on entertainment in subpart DG and schedule 6A are now located in subpart DD (Entertainment expenditure) of the 2004 Act.

STRUCTURE OF PART E

Introduction

In the absence of specific timing rules, the core provisions timing rules (sections BD 3 and BD 4) provide for timing to be determined on the basis of when *income* is "derived" or expenditure is "incurred". Sections BD 3 and BD 4 state that the meaning of "derived" and "incurred" is to continue to be determined by case law.

Part E is the location for sets of rules that have a predominant focus on matching or allocation. These rules apply where the policy is to provide a timing result that differs from the result arising from the time at which *income* is "derived" or expenditure or loss is "incurred".

As a number of the existing sets of such rules also deal with quantification, it is appropriate to signal that in the title of the Part.

Scope of Part E

Likewise, Part E now contains a range of provisions and sets of rules with differing operative effects. No general timing provisions exist, other than the generic rules relating to derivation and incurrence set out in the core provisions (sections BD 3 and BD 4 of the 2004 Act).

Nor has every element of a specific provision that has a timing aspect been shifted to Part E—such as a simple ancillary rule that clarifies for the avoidance of doubt when an amount is derived or incurred. From a reader's perspective, to shift such a simple ancillary rule would not provide sufficient benefit, since some *income* and *deduction* provisions have a close linkage to their timing element. When this occurs, the timing rule remains with the specific provision creating *income* or a *deduction*.

This approach has involved an exercise of judgment as to what is "ancillary", bearing in mind that the ultimate aim is to simplify access to the correct conclusion or application of the legislation.

> For example, in section CG 6 (2004 Act), the income is allocated to the income year in which the recovery is received.

In addition to the rules on depreciable assets, trading stock and revenue account property, Part E also covers areas within which the timing, *income* and *deduction* rules cannot easily be separated, such as the accrual rules, the international rules and many of the life insurance rules. However, these groups of rules have been drafted to identify the timed and quantified amount that a provision in Part C or D then makes, respectively, either *income* or a *deduction*.

Specific timing rules

Specific timing rules generally defer all or part of the *income* or *deduction* to one or more subsequent *tax years* or, conversely, permit the *income* or *deduction* to be allocated to an earlier income period.

Some timing rules do not allocate *income* or *deductions* as such, but merely have the effect of modifying the allocation that would otherwise occur.

> An example is the trading stock valuation rules, which provide for an adjustment through the treatment of the opening and closing values of trading stock as, respectively, a deduction and income.

The most significant specific timing rules are:

- Revenue account property (section EA 2 Other revenue account property).
- Accrual expenditure (section EA 3 Prepayments).
- Depreciation (subpart EE and section FB 7).
- Financial arrangement rules (subpart EW) and the old financial arrangement rules in sections EZ 30 to EZ 49.
- Valuation of trading stock, livestock, and bloodstock (section EA 1 and subparts EB, EC and ED).

Depreciation

Introduction

These provisions cover the various methods that are available for calculating depreciation for tax purposes. Depreciation is unusual from a legislative perspective in that it provides a deduction in relation to a capital item and, therefore, overrides the capital limitation rule in section DA 2(1).

Approach used in rewriting the depreciation rule

Deductibility under the 1994 Act

Under the depreciation rules in the 1994 Act, the interaction of section EG 1 with section EG 2(1)(e) (both of the 1994 Act) meant that the owner of a depreciable asset had to satisfy a test of deductibility in order to obtain a deduction for depreciation.

The test of deductibility in section EG 2(1)(e) of the 1994 Act produces a result that is almost identical to the outcomes under the general deductibility rules in BD 2(1)(b)(i) and (ii) (1994 Act). This meant the rule could be rationalised in the 2004 Act.

Deductibility under the 2004 Act

To be consistent with the approach adopted for other sets of rules in Part E, the depreciation rules preserve for Parts C and D the role of specifying what is *income* or a *deduction*. (See in the 2004 Act section CG 1 (depreciation recovery income) and section DA 1, where the *deduction* for *depreciation loss* is incorporated into *the general permission*.)

The relationship in the 2004 Act between *the general permission* (section DA 1) and section FB 7 (depreciation: partial income-producing use) operates to identify the extent to which a *deduction* is allowed for a *depreciation loss*. In addition, section DA 4 of the 2004 Act applies to override the *capital limitation* for a *depreciation loss*.

The amount of *depreciation loss* is determined under subpart EE of the 2004 Act, provided that the property is used or available for use in the *income year*.

Hence, the focus of the subpart EE depreciation rules is on the quantification of an amount of *depreciation loss* for an *income year* rather than on whether the *depreciation loss* is a *deduction* or not. This approach also clarifies the relationship between the depreciation rules and the general rules relating to deductibility of expenditure and loss.

From a drafting perspective, this rationalisation avoids the duplication of wording in the 1994 Act that required a similar link with income production in both the general rules (section BD 2(1)) and the depreciation rules (section EG 2(1)(e)).

Definitions

Because the depreciation rules have a broad application to the taxpaying community, specific depreciation-related definitions have been brought into subpart EE to be close to their operative provisions. However, the section OB 1 "dictionary" continues to list the definition (but cross-refers to the actual definition in subpart EE). In the 1994 Act, the definitions are spread between subpart EG and section OB 1.

Examples of these changes are:

- The definition of "adjusted tax value", located in section EE 46 of the 2004 Act.
- The provisions relating to ownership have been combined, and now specifically allow for joint ownership. These provisions are located in sections EE 2 to EE 5 of the 2004 Act. In the 1994 Act, the only express acknowledgement of the possibility of joint ownership is in section EG 19(8), which refers to disposals by partnerships.
- For reasons of clarity, the concept of disposals distinguishes between actual disposals and other events that are deemed to be disposals (sections EE 37 to EE 44 of the 2004 Act).

PARTS F TO END OF 2004 ACT

Consequential changes

Parts F to N have not been rewritten.

Even so, a number of consequential changes have been made to these parts, as well as to the schedules to the Act as a result of new and redefined terminology. The most common consequential changes required were those relating to the new or redefined core concepts of *income*, *excluded income*, *the general permission*, *tax year* and *income year*.

Discretions and self-assessment principles

In the 1994 Act, various discretions of the Commissioner of Inland Revenue are, in substance, objective tests. Therefore these discretions have been drafted as objective tests in the 2004 Act. This drafting approach is consistent with the principles of self-assessment and is not intended to change the effect of the law.

Depreciation

The apportionment rule formerly located in section EG 2(1)(e) of the 1994 Act is now located in section FB 7 of the 2004 Act.

Fringe benefit tax

Fringe benefit tax provisions that relate to the calculation and payment of fringe benefit tax have been relocated to subpart ND.

Part O

In section OB 1, there are a number of new definitions and some existing terms have been omitted or redefined. In the light of the select committee's comments on the rewritten Act in their commentary on the reported-back bill, it is important that readers check the definitions.

Operative definitions and definitions closely linked with major operative rules have been placed within the context of their relevant rules. This is intended to improve accessibility for the reader.

Section OD 9 is a new provision that consolidates the provisions in the 1994 Act relating to nominees.

Section OF 2(1) and (2) of the 1994 Act has been omitted, as its effect has been subsumed within the new term *tax year* and the redefined term *income year*.

Part Y

Part Y contains:

- Repeals of enactments (section YA 1 and schedule 20).
- Consequential changes required for other Acts of Parliament, including the Tax Administration Act 1994 (section YA 2 , Schedules 21 and 22).
- Transitional rules relating to the commencement of the 2004 Act (section YA 3).
- Savings of binding rulings (section YA 4).
- Savings of accrual determinations (section YA 5).

Transitional issues

Introduction

The following discussion of transitional issues outlines the drafting principles adopted and how those principles provide guidance for the intended effect of the transitional provisions. Also outlined is the recommendation of the select committee for dealing with unintended changes that may be discovered in the 2004 Act.

Testing for unintended changes in policy

It is reasonable to expect that a rewrite project such as this will result in inadvertent law changes. The courts may interpret new phrases and wording in a way that moves the interpretation of the rewritten Act away from the policy contained in the 1994 Act. For this reason, great care has been taken to ensure that the provisions in the 2004 Act are unambiguous and reflect the policy of the 1994 Act.

This has involved a process of testing and consultation on the drafting occurred throughout: from the development of the exposure draft, through to the introduction copy and reported-back versions of the bill.

This process ensured that each area of the drafts of legislation was reviewed on at least one occasion by a private sector tax specialist. Significant levels of private sector consultation also provide assurance that the rewritten legislation is intended to reflect accurately the current law (notified changes excepted, as set out in schedule 22A).

Transitional provisions

Transitional provisions are included in Part Y of the 2004 Act to ease the transition from the 1994 Act.

The transitional provisions indicate that:

- The plain words of the 2004 Act are to have full effect from commencement.
- No change in the effect of the law from the 1994 Act is intended (unless notified as a change in schedule 22A).

The 1994 Act can be used as an interpretive guide but only in cases where the meaning of a provision in the 2004 Act is unclear or gives rise to absurdity. This rule does not apply where changes in the law are intended and notified, or provisions in the Act are subsequently amended and introduce new policy.

The provisions of the 1994 Act may also be used to identify that an unintended change in policy has occurred in the rewritten Act. The transitional provisions do not address this situation, however, so a non-legislative process is being developed for the purpose.

The most important transitional provisions are those in sections A 2(2), YA 1(2) (Repeal of 1994 Act), YA 3(3), (4) and (5) (Intention of new law), and YA 4 (Saving of binding rulings).

Sections A 2(2) and YA 1(2)

The 2004 Act is to have full effect from and including the 2005–2006 *tax year*.

The 1994 Act has not been repealed in relation to earlier *tax years* and will continue to have full effect for those years. This treatment of the 1994 Act means that the 2004 Act does not require similar transitional provisions to section YB 5(1), (2) and (3) of the 1994 Act.

Even so, section YB 5(4) and (5) of the 1994 Act has been rewritten as section YA 3(1) and (2). This ensures that errors in other specific sources that reference corresponding provisions between the 1994 and 2004 Acts can be corrected, as contemplated by the Privy Council in the case of *Vela Fishing Ltd v CIR* (2003) 21 NZTC 18,123.

Section YA 3

Background

The transitional provisions adopted are intended to ensure that the 2004 Act takes effect from the beginning of the 2005–2006 *tax year*.

Broad objectives

The transitional provisions adopted are intended to:

- provide a clear signal to users of the new law that no change from the 1994 Act was intended (section YA 3(3))
- preserve existing case law and Inland Revenue practice and policy statements as much as is reasonably possible (section YA 3(3))
- require the 1994 Act to be used as a guide to interpreting the meaning of the rewritten Act where the meaning of the new law is unclear or ambiguous (section YA 3(4))
- ensure that each of the provisions listed in schedule 22A is not subject to the transitional provisions (section YA 3(5))
- ensure that any provision that has been amended to introduce new policy subsequent to the commencement of the 2004 Act is not subject to the transitional provisions (section YA 3(5)).

Unintended changes in policy

Background

It is still possible for a provision within the 2004 Act to contain an unintended change. However, where the provision is clear and does not lead to an absurdity, the 1994 Act cannot be used as a guide to interpretation. In this situation, the 1994 Act can only be used to support a submission that there has been an unintended change in policy.

The government has also given a commitment to promote retrospective amendments to the 2004 Act in circumstances where a provision in that Act contains an unintentional change in outcome of the law as compared to the 1994 Act. This commitment is intended to avoid disadvantaging any taxpayers who rely on the current law.

There will be occasions, however, when there will be differing views on whether a provision in the 2004 Act contains an unintended change in law. Therefore the government has established an independent committee to:

- consider any case brought to its attention on whether a provision in the 2004 Act has changed the effect of the law set out in the 1994 Act
- advise the government of its conclusion on each case.

This action is intended to give taxpayers confidence that there will be a transparent process in place in time for the commencement of the 2004 Act for determining whether it contains any changes in law.

Independent committee

A submission on the Income Tax Bill 2002 recommended that an independent committee be established to:

- review any submission that the rewritten legislation contains an unintended change to the meaning, application and operation of the law
- recommend an appropriate response to remedy such problems.

It recommended that this independent committee should be composed, at least, of representatives of the Institute of Chartered Accountants of New Zealand (ICANZ), the New Zealand Law Society, The Treasury, and Inland Revenue.

The select committee supported the submission and, as a result, the government has invited the Rewrite Advisory Panel, chaired by the Rt Hon Sir Ivor Richardson, to perform this role. The panel has accepted the invitation. The details for this process are being developed, and will be announced by the panel before the commencement of the 2004 Act.

The panel has a representative from the New Zealand Law Society, ICANZ, The Treasury, Inland Revenue and the independent chair.

Retrospective legislation and filed tax positions

An issue that arises whenever considering enacting retrospective legislation is that the changes may have an adverse impact on the previously filed tax positions of taxpayers. These impacts will be considered at the time of introducing the retrospective legislation.

Retention of unintended change

There remains the possibility that a future government will not accept the committee's recommendation and instead decide to retain the unintended change in policy. This arises because future governments and parliaments cannot be bound by a current government's policy or commitment to change the law.

Taxpayers who rely on the transitional provisions in coming to their tax position and who have been adversely affected by a government decision not to change the law, are still required to meet their tax obligations.

They may be entitled to relief from penalties and use-of-money interest, however. The relief is to be available only if the person involved has taken reasonable care in taking an acceptable tax position, as provided for in section 141A of the Tax Administration Act 1994.

If, however, a person takes an unacceptable tax position[16] resulting in a shortfall of tax in excess of the thresholds referred to in section 141B of the Tax Administration Act 1994, that person may be liable for penalties and use-of-money interest incurred.

[16] Section 141B Tax Administration Act 1994

Section YA 4 – binding rulings

Background

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 referred to in the ruling applies.

A significant consideration has been the potential cost to both taxpayers and Inland Revenue if it were necessary for new rulings to be issued in circumstances where existing binding rulings applied for a period which continued after the commencement of the rewritten legislation.

Alternatives considered

A number of possible approaches addressing the saving of binding rulings were considered as part of the development of transitional provisions for the 2004 Act. The option chosen expressly preserves the effect of existing binding rulings. Section YA 4 provides that a binding ruling continues to apply to the provisions of the 2004 Act that correspond to provisions of the 1994 Act that were the subject of the ruling.

> For example, if a binding ruling had been issued for three years, on the basis of the equivalent former legislation, with effect from the 2003–2004 tax year, the binding ruling remains in place until the end of the 2005–2006 tax year, notwithstanding the enactment of the 2004 Act.

The savings relating to binding rulings are not intended, however, to apply to any provision that does not have a corresponding provision in the old law. The two typical cases where this occurs are those provisions:

- listed in schedule 22A
- amending the 2004 Act to enact new policy.

The reference to the new law as being the law which "corresponds to the old law" is intended to give rise to an interpretation that facilitates Parliament's intention that taxpayers and Inland Revenue should not have to go to the time and effort of obtaining or issuing replacement binding rulings. To support this, section YA 4 provides that the Commissioner is prohibited from making a new binding ruling if the existing binding ruling is to continue to have effect. In other words, the intention is that the requirement that the new law "corresponds to the old law" is not intended to be given a narrow, obstructive interpretation that would prevent binding rulings being saved.

In the vast majority of cases, it is anticipated that there will be no doubt as to the existence of the "corresponding" new law. Almost invariably, it should be very clear that there is a new law which corresponds to and expresses the same ideas as the old law, even though it uses plainer language and is located under a different section number.

Section YA 5 – Savings of accrual determinations

The "preservation" approach adopted to save binding rulings has been applied to continue accrual determinations in a similar fashion.

Schedules

Schedule 6A

Schedule 6A of the 1994 Act has been incorporated into a number of the rewritten fringe benefit tax rules in subpart DD.

Schedule 22A

Background

Schedule 22A contains the list of policy changes that have been approved by the government for inclusion in the 2004 Act. The policy changes are minor in nature. They were exposed for consultation under the generic tax policy process either in issues papers released in 1998[17] or the exposure draft of the rewritten legislation.[18]

This schedule assists users in identifying the provisions to which sections YA 3 and YA 4 do not apply because they contain intended changes in policy and law. The following paragraphs outline the nature of the change for each of the provisions listed in schedule 22A of the 2004 Act.

Sections CB 6, CB 8(2), CB 9(2)

These provisions remove an ambiguity relating to the time of association in the land sales rules in sections CD 1(2)(b), (c) and (d) of the 1994 Act. In the 1994 Act, it was unclear whether the time of association in relation to the land provisions occurred at the time of acquisition or disposal of the land or at some other time.

The policy now places the test of association at the time land is acquired or in the case of builders, improved, rather than at the time of disposal.

Section CG 2(3)

In the 1994 Act, section CE 4(1) and (2) applied when a person had an allowable deduction in one income year, but a liability relating to that deduction was remitted or cancelled in a subsequent income year. When that section applied, the amount of the allowable deduction that was remitted or cancelled gave rise to a retrospective adjustment to a previously filed tax position.

In reviewing the policy of this section in the light of self-assessment, it was considered more practical for the rewritten Act to provide that this adjustment be made in the tax year the amount is remitted or cancelled.

[17] *Rewriting The Income Tax Act: Parts C, D and E [Issues Paper 1]* and *[Issues Paper 2]*, Policy Advice Division, Inland Revenue Department, 1998

[18] *Rewriting the Income Tax 1994: Exposure Draft,* published by the Policy Advice Division, Inland Revenue Department, September 2001.

The policy now treats the amount remitted as *income* in the *tax year* it is remitted, rather than in the year the *deduction* is allowed.

Section CG 4(3)

Sections DJ 1(c), DJ 5(2), DJ 7, DJ 8(1), DL 1(6), (12), and DL 4 (1) and (2) of the 1994 Act applied when a person had an allowable deduction in an income year, but a recovery relating to that deduction was made in a subsequent income year. When that section applied, the amount of the allowable deduction that was recovered gave rise to a retrospective adjustment to the previously filed tax position for the income year in which the person had the deduction.

The policy now treats the amount recovered as *income* in the *tax year* it is recovered, rather than in the year the *deduction* is allowed.

Section CG 5

Sections DF 3(3) and (4) of the 1994 Act applied to any benefit received by an employer from a superannuation scheme to which the employer had made employer superannuation contributions at any time. This provision reduced the employer's allowable deduction for the contributions made in the twelve-month period before the employer received the benefit. As this twelve-month period could cross two income years, it was possible for a retrospective adjustment to be made to a previously filed tax position.

The policy now treats that benefit received by the employer as *income* in the *tax year* the benefit arises, rather than as a reversal of *deductions* for contributions made in the twelve months before the benefit's receipt.

Section CU 17

In the specified mineral mining rules, a holding company is allowed a deduction for amounts written off by the holding company for loans made to a mining company. Sections DN 3(7) and (8) of the 1994 Act applied to reduce the deduction for the write-off if the holding company recovered or was treated as recovering any part of the written-off amount of that loan.

The policy now treats the amount repaid as *income* in the year it is repaid or treated as repaid, rather than in the year the deduction was allowed.

Section CW 15(1)

Under section CB 2(1)(c) of the 1994 Act, income derived by a non-resident for services performed in New Zealand was exempt from tax if certain criteria were met. One of the criteria related to whether the non-resident's visit exceeded 92 days during that tax year.

The 1994 legislation was unclear whether, for the purposes of this test, presence in New Zealand for part of a day—for example, on arrival or departure—is counted as one day. *Case K64* (1988) 10 NZTC 513 suggests that presence for part of a day does not count as presence for a whole day. To achieve consistency with the residence rule in section OE 1(4), presence for part of a day now counts as presence for a whole day for the purpose of this provision.

Section CW 32(3)

Section CW 32(3) clarifies the scope of the exemption in section CB 3(b)(i) of the 1994 Act. It ensures that the exemption is available for a qualifying beneficiary of a trust but not for the trustee of that trust.

Under the 1994 Act, it was unclear whether the limitation of the exemption applied to:

- Amounts derived by a public or local authority as trustee for a third party beneficiary.
- Amounts derived by a trustee that is not a public or local authority for a beneficiary that is a public or local authority.
- Amounts derived by a public or local authority that is a trust.

If a public or local authority derives *income* as a trustee, the *income* will generally be applied for the benefit of the trust's beneficiaries, who may or may not be entitled to the exemption. There is no guarantee that the *income* will all be applied for public or local authority purposes. Clearly, the exemption should not extend to amounts derived by a public or local authority as trustee for a third party beneficiary that is not beneficiary income.

As is usual in trust arrangements, the status of the beneficiary should be considered. Therefore if a trustee that is not a public or local authority derives *income* for a public or local authority beneficiary, the amount would constitute beneficiary income of the public or local authority and, therefore, form part of the authority's income. Beneficiary income having this nature would qualify as *exempt income* under the rewritten section CW 32(3).

The same policy or principle applies when the public or local authority has been established as a trust by an Act of Parliament: the trustee and beneficiary income should be dealt with as above.

Section CX 34(1)

This change provides consistency with the terminology used within the life insurance provisions.

Section CL 2 of the 1994 Act provides that the trustees of investing superannuation funds are not taxed on the proceeds of life insurance policies that have been issued in New Zealand.

The section has been rewritten as section CX 34(1) and altered to apply to life insurance policies offered or entered into in New Zealand. This makes the provision consistent with the other language used for the life insurance rules.

Section DB 7(6)

This change clarifies that the *deduction* allowed under section DB 7(6) (2004 Act) overrides the *withholding tax limitation*.

The policy in relation to interest incurred on money borrowed by a non-resident company that has a fixed establishment in New Zealand is to allow a deduction to the extent that the company incurs that interest in the course of carrying on a business through a fixed establishment in New Zealand.

If this money was borrowed from an unrelated non-resident, the interest paid would be non-resident withholding income derived by the lender from New Zealand[19] and subject to non-resident withholding tax as a final tax. In this situation the relationship between sections BD 2(2)(d) and BD 2(1)(b)(iii) of the 1994 Act was unclear.

However, section BD 2A does not refer to section BD 2(2)(d) (1994 Act), which prohibits a deduction for expenditure incurred in deriving schedular income subject to final withholding. An example of this income would be a dividend derived by a non-resident company from a New Zealand resident company. The implication is that the other prohibitions listed in section BD 2(2) would apply to deny a deduction for interest expenditure.

For example, a non-resident company carrying on business in New Zealand through a fixed establishment borrows money to acquire shares in a New Zealand resident company (not a group company). The shares are acquired as part of the business carried on through a permanent establishment in New Zealand.

Dividends derived by the branch operation of that non-resident company from the New Zealand company would be schedular income subject to final withholding, not exempt income. Section BD 2A would not apply. However, its existence suggests that interest on money borrowed by a company to acquire shares have a nexus with the dividend income arising from those shares. As that dividend income would be schedular income subject to final withholding, the general prohibition may override the specific deduction for the interest expense.

This relative priority in relation to the scheme of the Act was commented on by the Privy Council in the case of CIR v Mitsubishi Motors NZ Ltd.[20] In this case, the court noted that even though the general deduction rule may treat as an "allowable deduction", an expenditure treated as a deduction under a specific Part D provision, it is still possible for the limitations in section BD 2(2) to override that "allowable deduction".

If this interpretation were to be rewritten into the law, it would mean that in this example, the non-resident company would not have an allowable deduction for the interest incurred by its business carried on through the fixed establishment in New Zealand.

[19] Section OE 4(1)(m) or ((n)(ii)

[20] [PC] [1995] 3 NZLR 513; [1996] AC 315; (1995) 17 NZTC 12,351; 20 TRNZ 89

Section DD 2(6)

The wording of Part A (4)(c)(ii) of schedule 6A of the 1994 Act can be interpreted as meaning that expenditure on executive dining facilities falls within the ambit of the deductibility rules only when the area is reserved for certain levels of staff and their guests.

The original policy intent for this rule is that the limited deduction would apply irrespective of whether guests are involved. This is clarified in the rewritten section.

Section DE 12

Section DE 12 is a new provision that codifies current administrative practice and provides that Inland Revenue mileage rates may be used as the basis for measuring the business use of a motor vehicle.

To minimise compliance costs, Inland Revenue allowed taxpayers who claimed motor vehicle expenses under section BD 2 of the 1994 Act to use Inland Revenue mileage rates to calculate deductible expenses without keeping detailed records.

Inland Revenue allowed self-employed taxpayers, including members of a partnership, to use these mileage rates when the total distance travelled does not exceed 5,000 km in one year. This administrative concession appeared to conflict with section DH 1 of the 1994 Act, which stated that self-employed taxpayers, members of a partnership and trusts were allowed a deduction only under section DH 1 and associated provisions.

This administrative practice to allow the use of Inland Revenue mileage rates as a compliance cost reducing measure arose in 1990 from a recommendation of the Tax Simplification Committee. As significant numbers of business people use this system, it was considered that the system should be legislatively supported instead of relying on administrative practice.

Section DO 4(2)(c), (3)(c) and section DO 5

Section DO 3 of the 1994 Act (rewritten as sections DO 1 and DO 2 of the 2004 Act) allowed certain expenditure on assets to be an allowable deduction in the year the expenditure was incurred.

At the time of introduction of this provision in 1991, however, the overlap of the 1994 provisions, sections DO 3 and section DO 4, was not addressed. The overlap under the 1994 Act provisions was that owners and lessees of land who incurred expenditure that was an allowable deduction under section DO 3 could arguably choose to amortise that expenditure over a fixed period under section DO 4 of the 1994 Act.

In the 2004 Act, sections DO 4 (the owner of land) and DO 5 (lessee of land) address this overlap. These two sections do not apply to expenditure that is allowed as *deduction* under either of section DO 1 and DO 2 of the 2004 Act. This reflects the original policy intention.

Section EA 2(1)(e)

Petroleum mining deductions are excluded from the coverage of the revenue account property rule in section EA 2 of the 2004 Act.

In the 1994 Act, "revenue account property" is defined as

> … property which is trading stock of the person or otherwise property in respect of which any amount derived on disposition would be gross income of the person other than under section EG 19 [*depreciation recovered*].

Petroleum fell within this definition. As a result, under the 1994 Act, an overlap existed between the timing aspects of sections EF 2 and DM 1 (Treatment of petroleum mining exploration and development expenditure).

The rewritten legislation clarifies that the petroleum mining rules have priority by eliminating the overlap. This reflects the original policy intent and means that sections EJ 11 to EJ 18 (2004 Act) will determine the allocation of petroleum mining exploration and development expenditure.

Section EC 12(4)

Under sections EL 2(6) and EL 7(4) of the 1994 Act, it was unclear whether a livestock valuation election applying to a partnership should apply also to a partner's other interests. Although the standard rule was for the livestock election to apply to all the taxpayer's livestock, the underlying policy was intended to permit taxpayers to make a separate election for the partnership interest from that of their individual interests.

The 2004 Act overcomes this uncertainty by allowing a livestock election to be made separately for a partnership interest. Therefore taxpayers who own their own farm and are also a partner in another farming venture do not have to apply the same valuation method chosen for the partnership to livestock on their own farm.

Section EE 42(3)

Section EG 19(4) of the 1994 Act provides that, for partial business use of depreciable assets, the proportion of the amount of gross *income* or deduction on disposal is equal to the business use proportion. The 1994 Act achieves this by employing the following formula:

$$(a/(b - c)) \times d$$

In the formula, item "a" is all allowable deductions for depreciation and item "b" is the cost of the property to the taxpayer. This gives rise to an inconsistency between the disposal rule and the apportionment of deductions for depreciation provided for in section EG 2(1)(e) of the 1994 Act. This depreciation apportionment calculation for assets partially used in business is based on the base value of the asset (from the interaction of sections EG 2(1)(a) and (e) of the 1994 Act).

The policy intent on disposal of a depreciable asset (partial business use) is to apportion the gain or loss on disposal in the same business/private use proportion as the depreciation deductions were apportioned. Therefore the formula applying to the disposal should use the same terms, so the rewritten provision replaces the term "cost" with the term "base value".

Section EY 44(1)

Section EY 44(1) defines the time at which the group relationship must exist on transfer of a life insurance business between companies within a wholly owned group.

Under section CM 18 (1994 Act), it is unclear whether the companies have to be in the group for the whole of the income year or just when the transfer takes place.

The 2004 Act clarifies the original intent of the policy. It is now clear that both companies must be in the same wholly owned group at the time of the transfer rather than at any time during the *income year*.

Section EY 44(3)

This provision addresses a valuation issue arising following the transfer of a life insurance business. It defines the value transferees must use as the opening balance of actuarial reserves calculating their policyholder income following transfer.

Section CM 18 of the 1994 Act states that the opening balance of the actuarial reserves that a transferee must use in performing the policyholder base calculation is:

> ... the aggregate of the actuarial reserves of the life insurer in respect of all policies of life insurance for which the life insurer was the insurer immediately after the transfer.

Some submissions noted that this wording precludes consideration of any pre-existing life insurance business that the transferee may have had. Therefore the change clarifies the position to ensure that the pre-existing life insurance business of the transferee is also included in the opening actuarial reserves figure.

DRAFTING APPROACH

Objectives

The key aim of the rewrite is to produce tax legislation that is clear, uses plain language and is structurally consistent.

Therefore work since the Core Provisions Act has focused on refining the new structure, redrafting Parts A to E of the Act using plain language techniques and clarifying the structural relationships between the core provisions and Parts C, D and E.

To achieve this overall aim, the rewritten legislation has to be not only clear, but also technically accurate. Being technically accurate means the 2004 Act must reproduce the effect of the existing legislation, except when minor changes are intentionally made. These types of changes are made:

- in the interests of clarity or simplicity
- to better reflect intended policy, and
- to reflect intended changes in policy (schedule 22A).

Rewriting income tax legislation is seen as integral to increasing voluntary compliance with the tax laws. The reason is that legislation that is clear, uses plain language and is structurally consistent should make it easier for taxpayers to identify and comply with their income tax obligations.

Drafting techniques used

A number of drafting techniques have been used in rewriting the 1994 Act, including the incorporation of a number of elements of the Interpretation Act 1999. This approach is adopted because the trend in the courts is for income tax legislation to be interpreted in the same way as other Acts of Parliament. [21]

The rewrite cannot, however, eliminate all the complexity and inconsistency of tax law because the subject matter is inherently complex. The challenge has been to ensure the complexity results from the concepts rather than from the way the information is presented. The 2004 Act addresses this challenge through structure, drafting style and integrating the interpretive principles of the Interpretation Act 1999 into the drafting.

Structure

The overall scheme of the Act is determined from the structure and general application of the core provisions. This is complemented by the links to the different parts which provide the detail for the workings of the core provisions.

The structure of the 2004 Act is based on the structural principle of working from the most generally applicable provisions to the least generally applicable. This applies on an Act-wide basis as well as within each Part and subpart.

Parts and subparts

Subparts represent a grouping of provisions addressing similar or related rules.

For example, subpart CE addresses transactions relating to the income of employees and contractors.

Sections

At the section level, each section in Parts C to E has been rewritten to address a single concept. In some cases this has led to sections in the 1994 Act being broken up into a number of sections.

In the 2004 Act, the main operative rule of a section is located at the start of the section. Other subsections within that section are then drafted to supplement that main operative rule.

The 2004 Act also makes extensive use of signposts and cross-references to guide the reader to other relevant or related provisions.

Diagrams have been used in various places, and each section is followed by cross-references to the corresponding provision in the 1994 Act and a list of the defined terms in the section.

Drafting style

The drafting approach used is based on the style set out in the government discussion document *Rewriting the Income Tax Act – objectives, process, guidelines* (December 1994) in conjunction with the Parliamentary Counsel Office *Drafting Manual*.

Some examples of these guidelines are:

- Replacing archaic expressions with more modern ones, while taking care not to change the law inadvertently by rewriting words or expressions that have a well understood meaning.
- In some cases, using new defined terms when a term has a meaning that varies from its ordinary non-tax meaning. However, some terms have been retained because there is a depth of case history behind them, and simpler words of equivalent meaning cannot be found.
- Harmonising definitions throughout the Act where possible, which also makes it easier to find defined terms.
- Relocating the detail of definitions that are used for specific provisions from section OB 1 and placing them within the relevant provisions. However, a reference to the definition has been retained in section OB 1.
- Placing reliance on aspects of the Interpretation Act 1999.

Parts F to Z have been re-enacted with consequential changes for terminology. However, some provisions in Parts C, D and E in the 1994 Act have been relocated to other parts to ensure they fit within the structure for all Parts of the Act, as contemplated by the core provisions.

[21] *LAC Guidelines: Guidelines on process and content of legislation,* 2001 edition including the 2003 Supplement, May 2001, updated September 2003.

For example, section FB 7 (Depreciation: partial income-producing use) is an apportionment provision that was formerly located in section EG 2(1)(e) of the 1994 Act.

The other main example is the provisions relating to the calculation and payment of fringe benefit tax. These provisions have been relocated to subpart ND.

Purpose

The main rule for interpretation of statutes in New Zealand is contained in section 5(1) of the Interpretation Act 1999. Income tax legislation is not excluded from the application of this Act.

Section 5(1) reads as follows:

> The meaning of an enactment must be ascertained from its text and in the light of its purpose.

The guidelines indicate that there are some important considerations in understanding the application of this provision. They have been reflected in the drafting of section AA 2 of the Act.

- The purposive approach to interpretation has gained much ground in recent years.[22] Under this approach narrow "literal" meanings are not attributed to words if that would defeat Parliament's purpose.[23]

Therefore, to reflect the purpose of the legislation, the drafting approach adopted:

- Takes into account the scheme of the Act as a whole (being to impose tax).
- Takes into account the subject matter of the Part or subpart in which the section is situated.
- Takes into account the context of the section itself as well as the words in the section and relevant purpose provisions.
- Attempts to make the purpose more obvious by presenting the language and structure in a way that the reader can more easily identify the underlying policy from the most natural reading of the provision.
- Relies more on the general rules of interpretation set out in the Interpretation Act 1999.

Readers' aids

Readers' aids are contemplated by subsections 5(2) and (3) of the Interpretation Act 1999, which provide as follows:

> *(2) The matters that may be considered in ascertaining the meaning of an enactment include the indications provided in the enactment.*
>
> *(3) Examples of those indications are preambles, the analysis, a table of contents, headings to Parts and sections, marginal notes, diagrams, graphics, examples and explanatory material, and the organisation and format of the enactment.*

In addition to diagrams, flowcharts, notes and lists of defined terms, the drafting of the Act uses Part, subpart, section headings and subheadings within Parts. It also uses the way the provisions are organised and the structure of the provisions as a guide to the meaning of provisions.

A particular example of a readers' aid is the lists of defined terms following each section throughout Parts A to E. Section AA 3(2) describes the legal effect of the list of defined terms in section OB 1.

Defined terms

All defined terms in the Act are listed in section OB 1. The drafting approach adopted for definitions that are not widely used through the Act locates those terms close to their relevant operative provisions if that is likely to assist readers. Section OB 1 then lists that definition by pointing to the substantive definition. This location may be either within the section or within the relevant subpart.

The drafting style adopted for definitions led to some defined terms being introduced by the word "means" and of others by "includes". In the 2004 Act, the term "means" is used to introduce an exhaustive definition. The use of "includes" with a definition generally introduces an incomplete definition.

It is common in New Zealand Acts for an interpretation section to commence with the phrase "In this Act, unless the context otherwise requires". This phrase indicates that, particularly in a long Act, where the phrase in question appears several times, there may be occasions when it does not bear its defined meaning. However, it is important to note that the statutory definition is displaced only when there are strong contrary indications in the context.[24]

Another drafting feature of the 2004 Act is the omission from the list of defined terms in section OB 1 definitions having the same meaning as defined terms that appear in the Interpretation Act 1999.

[22] CIR v Official Assignee [CA] [2000] 2 NZLR 198; (2000) 19 NZTC 15,594 where Thomas J stated:
"Furthermore, this approach falls squarely within the principles now accepted for the interpretation of tax statutes. The rules which are applicable are no different from those applicable to any other statute. See IRC v McGuckian [1997] 3 All ER 817. Lord Steyn, delivering the main judgment, confirmed (at p 824) that the modern purposive approach to statutory construction applies to tax legislation no less than other legislation. The literal interpretation of tax statutes has given way to the purposive appr oach which requires the Court to consider the context and scheme of the Act as a whole and to have regard to the purpose of the legislative provision."

[23] CIR v Alcan NZ Ltd [1994] 3 NZLR 439; (1994) 16 NZTC 11,175; (1994) 18 TRNZ 715

[24] Discussed in such texts as Burrows Statute Law in New Zealand (2nd ed); Bennion Statutory Interpretation (3rd ed).

For example, the term "person", a defined term in the 1994 Act, is omitted from the 2004 Act because the defined term "person" in the Interpretation Act 1999 has all the components of the previous income tax definition.

Parts of speech and other grammatical forms of words

Section 32 of the Interpretation Act 1999 states:

> Parts of speech and grammatical forms of a word that is defined in an enactment have corresponding meanings in the same enactment.

Definitions in the 2004 Act do not state that different parts of speech or other grammatical forms of that word have a corresponding meaning. For example, it is not necessary to add to a definition of "sell" a statement that "sale" has a corresponding meaning.

Examples of defined terms for which this drafting approach has been adopted

Acquisition

The rewritten provisions use "acquisition" and "acquire" in place of expressions such as "acquires or becomes possessed of", "acquired or created" and "purchase or creation".

Disposal

The rewritten provisions use "disposal" instead of "sale or other disposition", "sale or other transfer", "alienation or transfer" and similar expressions. The verb used is "dispose".

Mainly

The rewritten provisions use "mainly" in place of "primarily and principally" and similar expressions. The expression "primarily and principally" was considered by Eichelbaum J in *Newman Tours Ltd* v *CIR* (1989) 11 NZTC 6,027 (High Court). The judge interpreted the expression as requiring that the purpose not only be the main one, in the sense of outweighing all the other purposes, singly or collectively, but also the primary one—that is, the first one. Sufficiently similar connotations can be conveyed in the single word "mainly".

They

The rewritten provisions use "they" and "their" as the singular pronoun in place of expressions such as "the taxpayer" or "the person" or the pronouns for which are, in traditional grammar, "his, her, or its". "They" as the singular pronoun is already used occasionally in the Act and is a common English usage.

For example, section EH 33(4)(b) of the 1994 Act.

Use of "they" and "their" in the rewritten provisions achieves drafting simplicity and consistency.

"Treated" in the 2004 Act

The rewritten provisions either omit "deemed" or use the word "treated" in its place.

Parts of speech, number and gender

Sections 31, 33, 35 and 36 of the Interpretation Act 1999 establish rules in relation to parts of speech, number and gender. The effects of these rules are that:

- in all Acts of Parliament, the singular includes the plural, and vice versa
- unless an income tax provision adopts a unique approach to the determination of time and distance, any references to time and distance used in the rewritten Act are to use the rules set out in the Interpretation Act 1999.

Ambulatory nature of law

Section 6 of the Interpretation Act 1999 provides that "An enactment applies to circumstances as they arise."

The provision recognises the fact that an Act of Parliament may last for many years and operate within a changed society where the courts must consider that circumstances are often very different from those in which it was originally enacted.

For example, the purpose of the foreign investment fund rules is to make sure that New Zealand residents who have overseas investments are taxed on their share of the overseas entity's income on a current basis.[25]

As the nature of investments evolves, the courts will be called on to consider to what extent a new form of investment may fall within one of the classes of foreign investment fund referred to in section EX 29.

To assist the courts in this area of interpretation, the drafters have striven to achieve an enduring piece of legislation through the use of plain language and clear structure.

Extrinsic materials

In rewriting the Act, a combination of plain language, structure, clear relationships and the principles of the Interpretation Act 1999 are all used to make the policy and intention of the law clear.

In adopting this approach, it was intended to reduce compliance and administration costs by minimising the need for the users to refer to extrinsic materials.

[25] IR 275B – Foreign Investment Funds [October 1994]

NEW DETERMINATIONS G9C AND G14B

Introduction

New Determinations G9C and G14B cover the treatment of foreign-denominated financial arrangements and forward contracts denominated in a foreign currency. They replace Determinations G9B and G14A but do not require any change in the treatment of financial arrangements that were formerly covered by those Determinations. Determinations G9A and G14 (which are not affected) cover the same types of arrangements, but use a different treatment to recognise both unrealised and unanticipated gains and losses. Taxpayers who made an election in 1998–1999 or 1999–2000 will be currently using Determinations G9B and G14A. Other taxpayers will be using Determinations G9A and G14.

Under Determinations G9C and G14B, taxpayers who have not previously made an election to use Determinations G9B and G14A will be able to use the treatment prescribed by those Determinations in the future. Access will be by election and certain conditions will apply to companies in groups. An election to use Determination G9C will include an election to use Determination G14B and vice versa. This mirrors the current requirement to use both Determinations G9B and G14A.

Any taxpayer currently using Determinations G9B and G14A will continue to use the same methodology under Determinations G9C and G14B.

Background

The accrual rule legislation under Division 2 of Part EH (sections EH 19 to EH 59) of the Income Tax Act 1994 was enacted in 1999, along with Determinations G9B and G14A after considerable consultation. The issues that led to these Determinations were discussed in the 1997 government discussion document *The Taxation of Financial Arrangements.* After further consultation, the determinations were published in the *New Zealand Gazette* on 7 May 1998 and in the May 1998 publication of the *Tax Information Bulletin,* Vol 10, No 5.

Determinations G9B and G14A were introduced as alternatives to Determinations G9A and G14. Taxpayers could elect to use them by using the methods described in the determinations for their returns for the years 1998–1999 or 1999–2000. Taxpayers who did not make such an election continue to use Determinations G9A and G14.

The fundamental difference between the two sets of determinations is that Determinations G9A and G14 recognise both anticipated and unanticipated gains and losses arising in each year from a financial arrangement, whilst Determinations G9B and G14A recognise only anticipated and realised gains and losses in each year, with unrealised, unanticipated gains and losses being recognised in the year in which the arrangement ends, or is deemed to end. In other words, Determinations G9B and G14A recognise unanticipated, but realised, gains and losses arising on interest flows or repayments of principal during the lifetime of a financial arrangement, as do Determinations G9A and G14. But the unrealised gains and losses arising from the change in value of the financial arrangement over time because of changing exchange rates are not recognised under Determinations G9B and G14A until the final year of the arrangement.

Determinations G9B and G14A more closely align with the intent of Division 2, which is to accrue over the term of the arrangement "a fair and reasonable amount of income derived from, or expenditure incurred under the arrangement, and so prevent deferring income and advancing expenditure".

The new determinations will allow those taxpayers who do not currently use Determinations G9B and G14A to use in the future the methods prescribed in those determinations to calculate their liability. The methodology prescribed in Determinations G9B and G14A has not been changed, and that is intended.

Application

Access will be by election made by giving notice in writing to the Commissioner. Taxpayers will be able to make the election to use Determinations G9C and G14B for the 2003–2004 income year if their accounts are open at 1 June 2004, and they make the election by the earlier of 31 July 2004 and their balance sheet date. To make the election to use the determinations for the 2004–2005 income year, taxpayers have until 31 July 2004, or 63 days after the beginning of their accounting year, whichever is later. For all following years, an election for an income year must be made by giving notice in writing to the Commissioner within 63 days of the commencement of the accounting period relating to that income year.

Where a company is within a group of companies (as defined by the Income Tax Act 1994, and effectively a 66% group) and the company has been using Determinations G9B and G14A, it will continue to do so for existing financial arrangements, regardless of the method used by other members of the group. However, if a member of the group (whether or not that member currently exists) wishes to make an election to use Determinations G9C and G14B, then the entire group must use the method under these determinations and must jointly give notice to the Commissioner that they wish to make the election.

Where Determination G9C is used, Determination G14B must also be used, as is the situation now with Determinations G9B and G14A.

Updating the Determination

The examples in the determinations have been updated to use the terminology of Division 2 of Part EH of the Income Tax Act 1994, rather than the terminology of Division 1 of Part EH.

Further clarification

In the questions and answers following, references to G9B or G9C are equally applicable to G14A or G14B respectively.

How do the determinations apply when companies within a group have different accounting periods?

When a number of companies within a group have different accounting years the significant date, in terms of the timing for the election, will be the earliest balance sheet date of a company within the group. For example, no company in group X has previously used G9B or G9C. Company A has a period of accounts beginning 1 January 2006. Company B, in the same group, has a period of accounts beginning 1 March 2006. The election to use G9C would have to be made within 63 days of 1 January 2006.

What happens when a new company comes into existence and an election has already been made by a group?

If a new company is formed, or a company migrates into New Zealand, and is part of a group that has already made an election, the new company will have to use the determinations. The members of the group have given notice to the Commissioner, and it does not matter that that company did not exist at the time that the election was made.

Which companies have to sign the notice?

The determination requires members of the group to give notice. "Group" is defined by reference to the Act (see Interpretation). The Act is the Income Tax Act 1994, and section OB 1 defines a group of companies by reference to section IG 1(2). This group includes non-resident companies. In practice, Inland Revenue will accept a notice given by all parties within the group who could be subject to the New Zealand accrual rules. When an existing non-resident group member comes into the New Zealand tax base, it will be bound by the election made by the group previously.

Does G9C replace G9B, and if so, does a company already using G9B have to make an election to use G9C?

G9C replaces G9B. It will apply to any financial arrangements entered into after the date the determination was signed. When financial arrangements are already held, section 90AE of the Tax Administration Act 1994 allows taxpayers to continue to use G9B for that arrangement until four years after publication. In practice, any taxpayers using G9B will continue to use the same methodology. It will not usually be necessary for those taxpayers to make an election. See G9C Scope (3), (b)(iii) and (iv).

What happens if a company within a group currently uses G9B but not all the members of the group do?

If a company is already using G9B it will continue to do so. The other group members do not have to use G9C if they do not make an election to do so, and do not already use G9B. However, if a company in the group wishes to use G9C and is not using G9B, then at that point all the members of the group will have to give notice and use the same determination. Clearly, the company that is already using G9B/G9C will not have to make a transitional adjustment but the remainder of the group will.

Authority

The determinations were made under sections 90(1)(c) and 90AC(1)(d) of the Tax Administration Act 1994. They were signed by Robin Oliver, General Manager of Policy Advice Division, on 3 June 2004. The full determinations follow.

DETERMINATION G9C: FINANCIAL ARRANGEMENTS THAT ARE DENOMINATED IN A CURRENCY OTHER THAN NEW ZEALAND DOLLARS: AN EXPECTED VALUE APPROACH

This determination may be cited as "Determination G9C: Financial arrangements that are denominated in a currency other than New Zealand dollars: an expected value approach".

This determination cancels and replaces Determination G9B: Financial arrangements that are denominated in a currency other than New Zealand dollars: an expected value approach.

1. Explanation (which does not form part of the determination)

When do you use this determination?

This determination applies to financial arrangements where the rights and obligations under the financial arrangement are fixed or otherwise determined in a currency other than NZD, including variable rate financial arrangements that are denominated in a currency other than NZD.

However, this determination only applies to financial arrangements where the payment dates are known not later than your first balance date after you become a party to the financial arrangement, and forward rates for the currency in which the financial arrangements are denominated can be determined.

You must use this determination for the 2003–04 income year and a financial arrangement for which this determination applies if—

- you are not a member of a group of companies and, on or before the day that is the earlier of 31 July 2004 and the end of your accounting period that corresponds to the 2003–04 income year, you give to the Commissioner notice in writing that you elect—
  - (a) to use this determination; and
  - (b) to use *Determination G14B: Forward contracts for foreign exchange and commodities: an expected value approach;*
- you are a member of a group of companies and, on or before the day that is the earlier of 31 July 2004 and the earliest day that is the end of an accounting period that corresponds to the 2003–04 income year for a member of the group, the members of the group give to the Commissioner notice in writing of an election—
  - (a) to use this determination; and
  - (b) to use *Determination G14B: Forward contracts for foreign exchange and commodities: an expected value approach*;

You must use this determination for the 2004–05 income year and a financial arrangement for which this determination applies if—

- you entered the financial arrangement after the date of this determination and were required to make a return of your income or expenditure for the 2003–04 income year on the basis of this determination, *Determination G9B* or *Determination G14A: Forward contracts for foreign exchange and commodities: an expected value approach*;
- you are not a member of a group of companies and, on or before the day that is the later of 31 July 2004 and the 63rd day of your accounting period that corresponds to the 2004–05 income year, you give to the Commissioner notice in writing that you elect—
  - (a) to use this determination; and
  - (b) to use *Determination G14B: Forward contracts for foreign exchange and commodities: an expected value approach*;
- you are a member of a group of companies and, on or before the day that is the later of 31 July 2004 and the earliest day that is the 63rd day of an accounting period that corresponds to the 2004–05 income year for a member of the group, the members of the group give to the Commissioner notice in writing of an election—
  - (a) to use this determination; and
  - (b) to use *Determination G14B: Forward contracts for foreign exchange and commodities: an expected value approach*.

You must use this determination for an income year beginning after the 2004–05 income year and a financial arrangement for which this determination applies if—

- you entered the financial arrangement after the date of this determination and were required to make a return of your income or expenditure for the 2004–05 income year on the basis of this determination, *Determination G9B* or *Determination G14A: Forward contracts for foreign exchange and commodities: an expected value approach*;
- you entered the financial arrangement before the date of this determination and you have made a return of your income or expenditure for an earlier income year and the financial arrangement on the basis of *Determination G9B* and are required under section 90 or sections 90AC and 90AE of the Tax Administration Act 1994 to make a return for the income year and the financial arrangement under this determination;
- you are not a member of a group of companies and, on or before the day that is the 63rd day of your accounting period that corresponds to the income year, you give to the Commissioner notice in writing that you elect—
  - (a) to use this determination; and
  - (b) to use *Determination G14B: Forward contracts for foreign exchange and commodities: an expected value approach*;
- you are a member of a group of companies and, on or before the earliest day that is the 63rd day of an accounting period that corresponds to the income year for a member of the group, the members of the group give to the Commissioner notice in writing of an election—
  - (a) to use this determination; and
  - (b) to use *Determination G14B: Forward contracts for foreign exchange and commodities: an expected value approach*.

You may not use this determination for an income year unless you are required to do so by the above paragraphs.

What methods can be used to calculate income or expenditure in relation to a financial arrangement that comes within the scope of this determination?

Expected value approach

This determination sets out an expected value approach to calculate gross income or expenditure from a financial arrangement where any rights and obligations of the parties are expressed in a base currency other than NZD. This base currency might be a foreign currency or a commodity. This expected value approach can only be used for financial arrangements within the scope of this determination, which is narrower than *Determination G9A: Financial Arrangements that are Denominated in a Currency or Commodity other than New Zealand Dollars*. If you are required to use this determination, you must not use *Determination G9A* for any such financial arrangement, and you must not use *Determination G14: Forward Contracts for Foreign Exchange and Commodities* for any forward contract within the scope of *Determination G14B: Forward contracts for foreign exchange and commodities: an expected value approach*.

Mark to spot approach

You can use *Determination G9A: Financial Arrangements that are Denominated in a Currency or Commodity other than New Zealand Dollars* to calculate gross income or expenditure of any financial arrangement within the scope of this determination if you are not required to use this determination or *Determination G14B: Forward contracts for foreign exchange and commodities: an expected value approach*.

Alternatively, you may use the mark to market method if you satisfy the requirements of section EH 1(6) of the Act or the market valuation method if you satisfy the requirements of section EH 36 of the Act.

You may also use a method allowed by the proviso to section EH 1(6) of the Act or by section EH 38(2) of the Act.

How do I use the method set out in this determination?

Under this method, the gross income or expenditure from a financial arrangement where the rights and obligations of the parties are expressed in a base currency other than NZD is the total of an expected component and an unexpected component.

To apply this method to a financial arrangement for the income year in which you enter the financial arrangement, you must—

- determine the expected component by taking into account all the base currency payments and payment dates in relation to the financial arrangement when you become a party to the financial arrangement; and
- use the initial interest rate to calculate the base currency payments under a variable rate financial arrangement denominated in a base currency other than NZD, and assume that this rate will apply throughout the term of the financial arrangement; and
- translate the base currency payments into expected NZD payments on the basis of the forward rates available at the time you become a party to the financial arrangement; and
- spread the expected NZD net amount under the yield to maturity method and allocate it to each income year over the term of the financial arrangement on a daily basis; and
- measure the unexpected component at the end of each balance date as the difference between actual and expected NZD payments.

To apply this method for the first time to a financial arrangement for an income year after the income year in which you enter the financial arrangement, you must calculate the gross income or expenditure of the financial arrangement as set out above, except that you must—

- in determining the expected component of the gross income or expenditure, use actual NZD payments up to the income year for which you first use this determination for the financial arrangement and expected NZD payments for the remaining term of the financial arrangement; and
- in calculating the expected NZD payments, use the relevant forward rates as at the end of the income year for which you first use this determination for the financial arrangement.

You must also calculate a transition allowance for a financial arrangement to which you apply the method for the first time for an income year that is after the income year in which you enter the financial arrangement.

How do I elect to use the method outlined in this determination?

Election for 2003–2004 and subsequent income years

If you are not a member of a group of companies, you may elect to use this determination for the 2003–04 and subsequent income years by giving a notice of election to the Commissioner on or before the day that is the earlier of 31 July 2004 and the day that is the end of your accounting period for the 2003–2004 income year. The notice must be in writing and elect—

- to use this determination; and
- to use *Determination G14B: Forward contracts for foreign exchange and commodities: an expected value approach*.

If you are a member of a group of companies, you may elect to use this determination for the 2003–2004 and subsequent income years by giving, together with all other m embers of the group, a notice of election to the Commissioner on or before the day that is the earlier of 31 July 2004 and the earliest day that is the end of an accounting period for the 2003–2004 income year for a member of the group. The notice must be in writing and elect—

- to use this determination; and
- to use *Determination G14B: Forward contracts for foreign exchange and commodities: an expected value approach*.

Election for 2004–2005 and subsequent income years

If you are not a member of a group of companies, you may elect to use this determination for the 2004–05 and subsequent income years by giving a notice of election to the Commissioner on or before the day that is the later of 31 July 2004 and the 63rd day of your accounting period for the 2004–2005 income year. The notice must be in writing and elect—

- to use this determination; and
- to use *Determination G14B: Forward contracts for foreign exchange and commodities: an expected value approach*.

If you are a member of a group of companies, you may elect to use this determination for the 2004–2005 and subsequent income years by giving, together with all other members of the group, a notice of election to the Commissioner on or before the day that is the later of 31 July 2004 and the earliest day that is the 63rd day of an accounting period for the 2004–2005 income year for a member of the group. The notice must be in writing and elect—

- to use this determination; and
- to use *Determination G14B: Forward contracts for foreign exchange and commodities: an expected value approach*.

Election for income years beginning after 2004–2005 income year

If you are not a member of a group of companies, you may elect to use this determination for an income year beginning after the 2004–2005 income year, and for subsequent income years, by giving a notice of election to the Commissioner on or before the day that is the 63rd day of your accounting period for the income year. The notice must be in writing and elect—

- to use this determination; and
- to use *Determination G14B: Forward contracts for foreign exchange and commodities: an expected value approach*.

If you are a member of a group of companies, you may elect to use this determination for an income year beginning after the 2004–2005 income year, and for subsequent income years, by giving, together with all other members of the group, a notice of election to the Commissioner on or before the earliest day that is the 63rd day of an accounting period for the income year for a member of the group. The notice must be in writing and elect—

- to use this determination; and
- to use *Determination G14B: Forward contracts for foreign exchange and commodities: an expected value approach*.

How do I calculate the transitional adjustment?

A transitional adjustment must be made for the first income year for which you are required to use this determination for a forward contract if you entered the forward contract before the income year and you have not been required to apply *Determination G9B* for the forward contract. The calculation is comparable to *Determination G25: Variations in the Terms of a Financial Arrangement*.

The transitional adjustment requires that for the income year of the adjustment you treat as gross income or expenditure the difference between the total amount that would have been gross income or expenditure calculated as described in this determination and the total amount actually recognised over the previous income years.

How is income or expenditure calculated in the year the financial arrangement matures or is disposed of?

Regardless of which method you choose to use, you must calculate income or expenditure using the base price adjustment in whichever of section EH 4 and section EH 47 of the Act is applicable to the financial arrangement.

Miscellaneous issues

This determination requires that where a financial arrangement involves or is expressed in more than one currency or commodity, each separate currency or commodity tranche is to be treated as a separate financial arrangement.

Where a facility provides for the rollover of a financial arrangement, the financial arrangement matures when the rollover occurs. Section EH 4 or section EH 47 of the Act applies in the income year the rollover occurs. Any payment arising from the rollover of a financial arrangement will be taken into account under section EH 4 or section EH 47 of the Act unless the payment is related to a separate financial arrangement.

2. Reference

This determination is made pursuant to section 90(1)(c) and 90AC(1)(d) of the Tax Administration Act 1994.

3. Scope

(1) This determination applies to the calculation of gross income or expenditure from a financial arrangement, to the extent that any right or obligation under the financial arrangement is fixed or otherwise determined in a currency other than NZD and is not fixed in NZD. The payment dates under the financial arrangement must be known not later than your first balance date after you become a party to the financial arrangement.

(2) This determination does not apply to—

- (a) a futures contract;
- (b) a security arrangement;
- (c) a financial arrangement denominated in a currency where the forward rates of the currency cannot be determined;
- (d) any financial arrangements covered by the following determinations:

  Determination G14: Forward Contracts for Foreign Exchange and Commodities;

  Determination G19: Exchange Traded Option Contracts;

  Determination G20: Discounted Value of Amounts Payable in Relation to Trade Credits Denominated in a Foreign Currency;

  Determination G21: Discounted Value of Amounts Payable in Relation to Deferred Property Settlements Denominated in a Foreign Currency;

  Determination G21A: Agreements for Sale and Purchase of Property Denominated in Foreign Currency: Discounted Value of Amounts Payable;

  Determination G27: Swaps;

  Determination G29: Agreements for Sale and Purchase of Property Denominated in Foreign Currency: Exchange Rate to Determine the Acquisition Price and Method for Spreading Income and Expenditure;

  except as specifically allowed by those determinations.

(3) You must use this determination for an income year for a financial arrangement that satisfies subparagraphs (1) and (2) above if—

- (a) the income year is the 2003–2004 income year and—
  - (i) you are not a member of a group of companies and make an election, as described in subparagraph (4) below, that applies for the 2003–2004 income year;
  - (ii) you are a member of a group of companies that makes an election, as described in subparagraph (4) below, that applies for the 2003–2004 income year;
- (b) the income year is after the 2003–2004 income year and—
  - (i) you are not a member of a group of companies and make an election, as described in subparagraph (4) below, that applies for the income year;
  - (ii) you are a member of a group of companies that makes an election, as described in subparagraph (4) below, that applies for the income year;
  - (iii) you entered the financial arrangement after the date of this determination and have been required to use this determination, *Determination G9B* or *Determination G14A* for an earlier income year;
  - (iv) you entered the financial arrangement before the date of this determination and have used *Determination G9B* for an earlier income year and the financial arrangement and are not excluded from the application of this determination for the income year and the financial arrangement by section 90(6) or 90AE of the Tax Administration Act 1994.

(4) An election to use this determination must—

- (a) be made in writing to the Commissioner; and
- (b) include an election to use *Determination G14B: Forward contracts for foreign exchange and commodities: an expected value approach*; and
- (c) if you are not a member of a group of companies, be made—
  - (i) on or before the day that is the earlier of 31 July 2004 and the end of your accounting period that corresponds to the 2003–2004 income year, if the election is to apply for the 2003–2004 and subsequent income years;
  - (ii) on or before the day that is the later of 31 July 2004 and the 63rd day of your accounting period that corresponds to the 2004–2005 income year, if the election is to apply for the 2004–2005 and subsequent income years;
  - (iii) on or before the day that is the 63rd day of your accounting period that corresponds to the income year, if the election is to apply for an income year that is after the 2004–2005 income year and for subsequent income years; and

(d) if you are a member of a group of companies, be made by all the members of the group and—
   (i) on or before the day that is the earlier of 31 July 2004 and the earliest day that is the end of an accounting period that corresponds to the 2003–2004 income year for a member of the group, if the election is to apply for the 2003–2004 and subsequent income years;
   (ii) on or before the day that is the later of 31 July 2004 and the earliest day that is the 63rd day of an accounting period that corresponds to the 2004–2005 income year for a member of the group, if the election is to apply for the 2004–2005 and subsequent income years;
   (iii) on or before the earliest day that is the 63rd day of an accounting period that corresponds to the income year for a member of the group, if the election is to apply for an income year that is after the 2004–2005 income year and for subsequent income years.

(5) If you must use this determination, you may not use—
   (a) *Determination G9A: Financial Arrangements that are Denominated in a Currency or Commodity other than New Zealand Dollars* to calculate gross income or expenditure of any financial arrangement that is within subparagraphs (1) and (2) above;
   (b) *Determination G14: Forward Contracts for Foreign Exchange and Commodities* to calculate gross income or expenditure of any forward contract that is within the scope of *Determination G14B: Forward contracts for foreign exchange and commodities: an expected value approach*.

(**Note**: A determination to which *Determination G9C* refers may be changed or rescinded by a new determination made by the Commissioner. In such a case, a reference to the old determination is extended to the new determination.)

4. Principle

(1) If you are a party to a financial arrangement to which this determination applies, the gross income or expenditure in respect of the financial arrangement is calculated by taking into account all amounts arising from the fluctuations of exchange rates or commodity prices.

(2) The gross income or expenditure from the financial arrangement is the total of an expected component and an unexpected component.

(3) If you must apply this determination to a financial arrangement for the income year in which you enter the financial arrangement, you must measure the expected component as at the time you enter the financial arrangement. You must also recognise the unexpected component when it is realised.

(4) To measure the expected component you must convert the base currency payments into expected NZD payments on the basis of forward rates at the time you enter the financial arrangement and spread the expected NZD net amount over the term of the financial arrangement.

(5) You must measure the unexpected component as the difference between the actual NZD payments and the expected NZD payments.

(6) If you must apply this determination for the first time to a financial arrangement for an income year that is after the income year in which you enter the financial arrangement, and you have not applied *Determination G9B* for the financial arrangement, you must measure the expected component as at the end of the income year. You must follow the principle set out above by calculating the expected NZD net amount using actual NZD payments up to the end of the income year in which you first apply the determination and the forward rates at the end of that income year.

(7) Again, you must recognise the unexpected component when it is realised.

Transitional adjustment

(8) For the first income year for which you must use this determination, you must perform the transitional adjustment calculation to calculate gross income or expenditure for all financial arrangements:
   (a) that you entered before the income year; and
   (b) for which you have not been required to use *Determination G9B*.

(9) This adjustment ensures that the gross income or expenditure up to the end of the income year in which you first use this determination is equal to that that would have been returned if the actual NZD payments and the forward rates, as described in subparagraph (4), and this determination had been used since you became a party to the financial arrangement.

5. Interpretation

(1) In this determination, a reference to the **Act** is a reference to the Income Tax Act 1994.

(2) In this determination—

base currency in relation to a financial arrangement means the currency or commodity in which rights and obligations under the financial arrangement are fixed

covered interest parity means the proposition that the differential between forward and spot exchange rates is equal to the interest differentials. That is, the forward rate for a foreign currency exchange at time t for 1 period ahead is equivalent to the spot rate at time t, S_t, multiplied by 1 plus the foreign interest rate, i_f, divided by 1 plus the domestic interest rate, i_d. Forward rates at time t for n periods, $Fwd_{t,n}$, can thus be derived based on the principle of covered interest parity as—

$$Fwd_{t,n} = S_t \times \frac{(1 + i_f)^n}{(1 + i_d)^n}$$

currency includes any commodity used as a medium of exchange or account, whether in general use or for the purpose of an arrangement

exchange rate means the price of 1 currency expressed in another currency

financial arrangement has the same meaning as in the Act:
Provided that, where a financial arrangement creates obligations in 2 or more currencies or commodities and the consideration to be given and received in respect of the obligations in each of the currencies is separately identifiable, the consideration to be given and received in respect of the obligations in each currency will be treated as relating to separate financial arrangements

floating rate arrangement means a financial arrangement where the interest rate is reset periodically according to a predetermined formula, linking the interest rate to an indicator rate such as the bank bill or interbank rate

forward rate means the exchange rate for a forward contract as defined in *Determination G6D: Foreign Currency Rates* or the forward exchange rate calculated using the principle of covered interest parity or other methods that are commercially acceptable. In the case where the base currency is a commodity, the forward rate is the future value of the commodity (in NZD)

future value in relation to a commodity and a future date means the value of the commodity at the future date, on a given date, derived from any commercially acceptable, market-based method of valuation

GBP means the currency of the United Kingdom

initial interest rate in relation to a financial arrangement means the interest rate that applies to the first period after the date of issue or acquisition of the financial arrangement

interest means any periodic payment in relation to the financial arrangement, to the extent intended to provide a return to the lender on the sums provided to the borrower. It does not include fees, discounts, premiums, or payments effecting a reduction of principal

NZD means the currency of New Zealand

period means a term commencing immediately after a payment is payable or receivable, and ending when the next payment is payable or receivable

reviewable rate arrangement means a financial arrangement where the interest rate is set periodically in line with market rates

spot rate means the exchange rate for a spot contract as defined in *Determination G6D: Foreign Currency Rates* or in the case of a commodity, the spot value (in NZD) of the commodity

spot value in relation to a commodity and a day means the value of the commodity on that day derived from any commercially acceptable method of valuation

USD means the currency of the United States of America

variable rate financial arrangement means a floating rate arrangement or a reviewable rate arrangement.

(3) All other terms used have the meaning given to them for the purpose of the Act.

6. Method

(1) Your gross income or expenditure in an income year from a financial arrangement under this determination is the total of—
  (a) the expected component, calculated in accordance with subparagraphs (2) to (5); and
  (b) the unexpected component, calculated in accordance with subparagraph (6).

(2) If the first income year for which you are required to apply this determination to a financial arrangement is the income year in which you become a party to the financial arrangement, you must calculate the expected component for each income year of the remaining term of the financial arrangement as at the time you become a party to the financial arrangement. The expected component is calculated by first taking into account all base currency payments in relation to the financial arrangement.

(3) You must calculate the base currency payments of a variable rate financial arrangement denominated in a currency other than NZD using the initial interest rate and assuming that this rate will apply throughout the term of the financial arrangement.

(4) You must convert the base currency payments into NZD using forward rates as at the time you became a party to the financial arrangement.

(5) You must spread the expected NZD net amount using the yield to maturity method consistent with *Determination G3* and, where necessary, allocate it to the income year on the basis of *Determination G1A*. This will give the expected component for each income year.

(6) You must calculate and recognise the unexpected component for each income year. The unexpected component is the difference between the actual NZD value of the payments during the year and the expected NZD value of those payments as calculated under subparagraph (4).

(7) If the first income year for which you are required to apply this determination to a financial arrangement is after the income year in which you entered the financial arrangement, and you have not been required to use *Determination G9B* for the financial arrangement, you must follow the method set out in subparagraphs (1) to (6) to calculate gross income or expenditure of the financial arrangement, except that—
- (a) the NZD net amount to be spread under subparagraph (5) consists of—
  - (i) actual NZD payments that have occurred since you became a party to the financial arrangement until the end of the first income year for which you must use this determination;
  - (ii) expected NZD payments in the remaining term of the financial arrangement; and
- (b) the expected NZD payments in the remaining term of the financial arrangement must be calculated on the basis of the forward rates available at the end of the first income year for which you must use this determination for the financial arrangement.

Transitional adjustment for existing financial arrangements

(8) You must perform a transitional adjustment calculation for the first income year for which you must use this determination to calculate gross income or expenditure of any financial arrangement if you entered the financial arrangement before the income year and have not been required to apply *Determination G9B* to the financial arrangement. You must perform the transitional adjustment calculation for each such financial arrangement in accordance with the following formula:

$$a - b - c + d$$

where—

a is the sum of all amounts that would have been income in respect of the financial arrangement from the time it was entered into until the end of the income year, if this determination had applied from the time you became a party to the financial arrangement

b is the sum of all amounts that would have been expenditure in respect of the financial arrangement from the time it was entered into until the end of the income year, if this determination had applied from the time you became a party to the financial arrangement

c is the sum of all income in respect of the financial arrangement since it was acquired until the end of the previous income year

d is the sum of all expenditure in respect of the financial arrangement since it was acquired until the end of the previous income year.

A positive net amount is gross income while a negative net amount is gross expenditure in the first income year for which you must use this determination.

7. Examples

(1) A New Zealand investor holds a United States Treasury Bond on its balance date of 30 June 2005. The bond has a term of 5 years and bears 10% interest payable semi-annually on 1 September and 1 March. It has a face value of USD $10,000,000. The bond was purchased at issue for USD $8,300,000 and matures on 1 September 2009.

(2) The New Zealand investor has to calculate the expected NZD net amount on the basis of forward rates available at the time it becomes a party to the financial arrangement. It then has to spread and allocate the expected NZD net amount to the income years over the term of the financial arrangement in accordance with *Determination G3* and *Determination G1A*. In each of those income years, the investor also has to determine the unexpected component of the gross income or expenditure. The unexpected component is measured as the difference between the actual NZD payments and the expected NZD payments.

Further examples are provided in the schedule.

Signed on the 3rd day of June 2004.

Robin Oliver
General Manager, Policy

Schedule: Further examples

Note: In each example involving a base price adjustment, the base price adjustment is calculated on the assumption that the financial arrangement is subject to Division 2 of Part EH of the Act. The details of the calculation would differ for a financial arrangement that was subject to Division 1 of Part EH of the Act.

Example A: Discounted bond

A NZ investor holds a United States Treasury Bond on its balance date of 30 June 2005. The bond has a term of 5 years and bears 10% interest payable semi-annually on 1 September and 1 March. It has a face value of USD $10,000,000. The bond was purchased at issue for USD $8,300,000 and matures on 1 September 2009.

The following table presents the spot rates at the relevant dates and the forward rates at the time of contract out to the relevant dates. The forward rates were estimated based on the principle of covered interest parity using the interest rates in the US (US,I), the domestic interest rates (NZ,I) and the spot rate at the time of contract. In this simple example the (US,I) and the (NZ,I) were assumed to be 10% per annum and 8% per annum, respectively, and they remain constant throughout the entire period (assuming a horizontal yield curve so that a 6-month bond and a 5-year bond have the same rate).

Date	Spot	Fwd (0,t)	US,I	NZ,I
1-Sep-04	0.6310	0.6310	0.05	0.04
1-Mar-05	0.6455	0.6371	0.05	0.04
1-Sep-05	0.6500	0.6432	0.05	0.04
1-Mar-06	0.6550	0.6494	0.05	0.04
1-Sep-06	0.6570	0.6556	0.05	0.04
1-Mar-07	0.6580	0.6619	0.05	0.04
1-Sep-07	0.6400	0.6683	0.05	0.04
1-Mar-08	0.6380	0.6747	0.05	0.04
1-Sep-08	0.6150	0.6812	0.05	0.04
1-Mar-09	0.6150	0.6878	0.05	0.04
1-Sep-09	0.6150	0.6944	0.05	0.04

At the time of contract – 1 September 2004

Given the above assumptions, the payments in USD expected at the time of contract (see column (a)), could be converted to NZD based on the forward rates at each relevant date (see column (b)). The expected NZD net amount represents a yield of approximately 12% per annum over the 5-year period and the yield is spread in a way consistent with *Determination G3*. The value of NZD $848,432, for instance, is the expected component of the gross income for the NZ investor for the 6-month period ending 1 March 2005.

Date	(a) USD Cash	(b) Expected cash (NZD)	(c) Expected income
1-Sep-04	-8,300,000	-13,153,724	
1-Mar-05	500,000	784,846	848,432
1-Sep-05	500,000	777,372	852,533
1-Mar-06	500,000	769,968	857,381
1-Sep-06	500,000	762,635	863,020
1-Mar-07	500,000	755,372	869,494
1-Sep-07	500,000	748,178	876,855
1-Mar-08	500,000	741,052	885,155
1-Sep-08	500,000	733,995	894,450
1-Mar-09	500,000	727,004	904,800
1-Sep-09	10,500,000	15,121,690	916,268
	6,700,000	8,768,389	8,768,389
6-month YTM	7%	6%	

When cash is subsequently received at the relevant dates, the NZD values of the payments are likely to differ from those expected at the contract date. Where the NZD values of these subsequent payments deviate from the expected NZD values, they give rise to unexpected component of the gross income or expenditure. For example, on 1 March 2005 the actual payment was NZD $774,593 while the expected payment was NZD $784,846. The discrepancy of NZD $10,253 is the unexpected component for the period ending 30 June 2005.

Date	Expected cash (NZD)	Actual cash (NZD)	Unexpected income/ expenditure
1-Sep-04	-13,153,724	-13,153,724	
1-Mar-05	784,846	774,593	-10,253
1-Sep-05	777,372	769,231	-8,141
1-Mar-06	769,968	763,359	-6,609
1-Sep-06	762,635	761,035	-1,600
1-Mar-07	755,372	759,878	4,506
1-Sep-07	748,178	781,250	33,072
1-Mar-08	741,052	783,699	42,647
1-Sep-08	733,995	813,008	79,013
1-Mar-09	727,004	813,008	86,004
1-Sep-09	15,121,690	17,073,171	1,951,480
	8,768,389		2,170,119

At the first balance date – 30 June 2005

There are 2 components to the income or expenditure for the financial arrangement in this income year: the gains expected at the contract date and the unexpected losses. The expected gains as summarised above are allocated to the income year in a way consistent with *Determination G1A*. Therefore, the gross income or expenditure for the year ended 30 June 2005 is—

($848,432) + (121/184 × $852,533) – $10,253 = $1,398,812

where NZD $1,398,812 is gross income of the NZ investor.

At the second balance date – 30 June 2006

The gross income or expenditure at 30 June 2006 is calculated as—

(63/184 × $852,533) + ($857,381) +(121/184 × $863,020) – $8,141 – $6,609 = $1,702,060

where NZD $1,702,060 is gross income of the NZ investor.

At the third balance date – 30 June 2007

The gross income or expenditure at 30 June 2007 is calculated as—

(63/184 × $863,020) + ($869,494) + (121/184 × $876,855) – $1,600 + $4,506 = $1,744,518

where NZD $1,744,518 is gross income of the NZ investor.

On 30 September 2007 the bond is sold for USD $10,000,000 (ie an approximate yield of 16% pa). At this date the USD/NZD spot rate was 0.6320. At this date the investor is subject to the base price adjustment under section EH 47—

consideration – income + expenditure + amount remitted

where—

consideration is the consideration paid or payable to the company less the consideration paid or payable by the company:

= 500,000/.6455 + 500,000/.6500 + 500,000/.6550 + 500,000/.6570 + 500,000/.6580 +500,000.6400 + 10,000,000/.6320 - 8,300,000/.6310

= $20,432,131 - $13,153,724

= NZD $7,278,407

income is all the amounts of gross income derived in previous income years

= 1,398,812 + 1,702,060 + 1,744,518 (as calculated above) = NZD $4,845,390

expenditure is expenditure incurred in previous income years

= 0

amount remitted is the amount of consideration remitted

= 0.

So the base price adjustment is—

consideration – income + expenditure + amount remitted

= 7,278,407 – 4,845,390 + 0 + 0

= NZD $2,433,017.

Since this is a positive amount it is gross income of the NZ investor in this income year.

Example B: Discounted bond entered into before the 2003–2004 income year

A NZ investor holds a United States Treasury Bond on its balance date of 30 June 2004. The bond has a term of 5 years and bears 10% interest payable semi-annually on 1 September and 1 March. It has a face value of USD $10,000,000. The bond was purchased at issue for USD $8,300,000 and matures on 1 September 2007.

This is effectively the same as Example A except that the discounted bond was acquired on 1 September 2002. The following table presents the spot rates at the relevant dates and the forward rates at the time of contract out to the relevant dates as in Example A.

Date	Spot	Fwd (0,t)	US,I	NZ,I
1-Sep-02	0.6310	0.6310	0.05	0.04
1-Mar-03	0.6455	0.6371	0.05	0.04
1-Sep-03	0.6500	0.6432	0.05	0.04
1-Mar-04	0.6550	0.6494	0.05	0.04
1-Sep-04	0.6570	0.6556	0.05	0.04
1-Mar- 05	0.6580	0.6619	0.05	0.04
1-Sep-05	0.6400	0.6683	0.05	0.04
1-Mar-06	0.6380	0.6747	0.05	0.04
1-Sep-06	0.6150	0.6812	0.05	0.04
1-Mar-07	0.6150	0.6878	0.05	0.04
1-Sep-07	0.6150	0.6944	0.05	0.04

In the 2003–2004 income year – 30 June 2004

The gross income or expenditure under the discounted bond has been calculated in previous income years according to *Determination G9A*. The corporate has already recognised gross income of $1,398,812 in the 30 June 2003 income year.

However, the corporate has elected to adopt this determination from the 2003–04 income year. The expected NZD net amount to be spread under this determination must, therefore, be determined at the end of the 2003–04 income year. The following table summarises the actual payments from 1 September 2002 to the end of the 2003–04 income year and the expected NZD payments for the remaining term of the financial arrangement. These expected NZD payments were calculated on the basis of the forward rates at 30 June 2004 out to the relevant dates. For the sake of simplicity, these forward rates are assumed to be the same, in this example, as those measured at the time of contract. In practice, however, the forward rates measured at the time of contract are rarely the same as the forward rates measured at a later date.

Date	Expected cash (NZD)	Expected income
1-Sep-02	-13,53,724	
1-Mar-03	774,593	845,427
1-Sep-03	769,231	849,980
1-Mar-04	763,359	855,170
1-Sep-04	762,635	861,071
1-Mar-05	755,372	867,397
1-Sep-05	748,178	874,598
1-Mar-06	741,052	882,723
1-Sep-06	733,995	891,829
1-Mar-0 7	727,004	901,973
1-Sep-07	15,121,690	913,219
	8,743,386	
6-month YTM	6%	

At the end of the 2003–04 income year, the expected NZD net amount in relation to the discounted bond is NZD $8,743,386, representing an annual yield of approximately 12%. The expected NZD net amount is spread over the term of the financial arrangement in a way consistent with *Determination G3*.

The transitional adjustment in the 2003–04 income year is—

a – b – c + d

where—

a is the sum of all amounts that would have been income from the time the financial arrangement was entered into until the end of the 2003–04 income year

= 845,427 + 849,980 + 855,170 + 861,071 × 121/184

= $3,116,825

b is the sum of all amounts that would have been expenditure from the time the financial arrangement was entered into until the end of the 2003–04 income year
= 0

c is the sum of all income in respect of the financial arrangement since it was acquired until the end of the previous income year
= $1,398,812

d is the sum of all expenditure in respect of the financial arrangement since it was acquired until the end of the previous income year
= 0.

The net amount of NZD $1,71 8,013 is gross income in the 2003–04 income year.

The income or expenditure in relation to the discounted bond in subsequent income years will be calculated as in Example A. The expected component of the gross income or expenditure is determined as summarised in the table above while the unexpected component is calculated as in Example A.

Example C: Multi-currency loan facility with early repayment

A corporate borrower has a multi-currency loan facility that allows funds to be drawn down in any of three currencies—US Dollars (USD), Sterling (GBP) and Deutschemarks (DM). The total initial amount of the loan is USD $100,000,000 and may be taken in any combination of the three currencies. The term of the loan facility is 10 years and any tranche may be repaid at any time by payment of the principal outstanding. The mixture of currencies can be changed at each 6-monthly interest payment date. Interest is payable in the currency of the principal amount at rates depending on the currency as shown on the following page.

The loan is initially drawn down on 1 October 2004 in the configuration below. Interest is payable 6-monthly in arrears on 1 February and 1 August. The corporate borrower has a 31 March balance date. Its base currency is NZD.

Initial drawn down configuration				
Currency	**Amount**	**Spot rate (against USD)**	**USD equiv**	**Interest rate**
USD	$55m		$55m	9%
GBP	STG36m	0.5500	$19.8m	11%
DM	DM60m	0.4083	$24.5m	5%
		Total	$99.3m	

For the purpose of illustration, the spot rates and the forward rates at the initial drawn down date out to the relevant dates for GBP/NZD are presented below. The forward rates were estimated based on the principle of covered interest parity using the interest rates in the UK (UK,I), the domestic interest rates (NZ,I) and the spot rate at the initial drawn down date. In this simple example the (UK,I) and the (NZ,I) were assumed to be 10% per annum and 8% per annum, respectively, and they remain constant throughout the entire period (assuming a horizontal yield curve so that a 6-month bond and a 10-year bond have the same rate).

Date	Actual spot	CIP Fwd (0,t)	Expected UK,I	Expected NZ,I
1-Oct-04	0.3300	0.3300	0.05	0.04
1-Feb-05	0.3345	0.3332	0.05	0.04
1-Aug-05	0.3340	0.3364	0.05	0.04
1-Feb-06	0.3310	0.3396	0.05	0.04
1-Aug-06	0.3184	0.3429	0.05	0.04
1-Feb-07	0.3046	0.3462	0.05	0.04
1-Aug-07	0.3387	0.3495	0.05	0.04
1-Feb-08	0.3024	0.3529	0.05	0.04
1-Aug-08	0.2829	0.3563	0.05	0.04
1-Feb-09	0.3503	0.3597	0.05	0.04
1-Aug-09	0.3736	0.3631	0.05	0.04
1-Feb-10	0.3773	0.3666	0.05	0.04
1-Aug-10	0.3874	0.3702	0.05	0.04
1-Feb-11	0.4034	0.3737	0.05	0.04
1-Aug-11	0.4225	0.3773	0.05	0.04
1-Feb-12	0.4435	0.3809	0.05	0.04
1-Aug-12	0.4414	0.3846	0.05	0.04
1-Feb-13	0.4296	0.3883	0.05	0.04
1-Aug-13	0.3955	0.3920	0.05	0.04
1-Feb-14	0.3953	0.3958	0.05	0.04
1-Aug-14	0.3953	0.3996	0.05	0.04
1-Oct-14	0.3953	0.4034	0.05	0.04

For taxation purposes each of these tranches is treated as a separate financial arrangement. The following example illustrates the way gross income or expenditure with respect to the sterling (GBP) tranche is calculated at the initial drawn-down date and the subsequent balance dates.

At the initial drawn-down date – 1 October 2004

At the initial drawn down date, the expected payments in GBP and NZD over the 10-year period are as follows:

Date	(a) GBP cash	(b) Expected cash NZD	(c) Expected expenditure
1-Oct-04	36,000,000	109,090,909	
1-Feb-05	-1,320,000	-3,961,905	4,646,006
1-Aug-05	-1,980,000	-5,886,259	4,675,141
1-Feb-06	-1,980,000	-5,830,199	4,623,561
1-Aug-06	-1,980,000	-5,774,673	4,572,173
1-Feb-07	-1,980,000	-5,719,676	4,520,960
1-Aug-07	-1,980,000	-5,665,203	4,469,909
1-Feb-08	-1,980,000	-5,611,249	4,419,003
1-Aug-08	-1,980,000	-5,557,808	4,368,227
1-Feb-09	-1,980,000	-5,504,877	4,317,565
1-Aug-09	-1,980,000	-5,452,450	4,266,999
1-Feb-10	-1,980,000	-5,400,521	4,216,513
1-Aug-10	-1,980,000	-5,349,088	4,166,088
1-Feb-11	-1,980,000	-5,298,144	4,115,706
1-Aug-11	-1,980,000	-5,247,686	4,065,347
1-Feb-12	-1,980,000	-5,197,708	4,014,993
1-Aug-12	-1,980,000	-5,148,206	3,964,624
1-Feb-13	-1,980,000	-5,099,175	3,914,217
1-Aug-13	-1,980,000	-5,050,612	3,863,751
1-Feb-14	-1,980,000	-5,002,511	3,813,205
1-Aug-14	-36,980,000	-4,954,868	3,762,554
1-Oct-14	-39,660,000	-90,866,409	3,711,775
Total	-600,000	-88,488,316	88,488,316
6-month YTM	5%	4%	

On 1 October 2004 the corporate borrower received GBP £36,000,000, which is equivalent to NZD $109,090,909. On 1 February 2005, the interest payment in arrears for the 4 months from the initial drawn down date amounts to GBP £1,320,000, which is equivalent to NZD $3,961,905 (valued at the relevant forward rate of 0.3332 at the initial drawn down date). The subsequent interest payments were also converted to NZD in the same way. Overall NZD net amount of $88,488,316 represent an expected yield of approximately 8% per annum. The expected yield is spread according to *Determination G3* (see column (c)).

The actual NZD payments will deviate from the expected NZD payments due to fluctuations in the exchange rates. For instance, the actual NZD payment on 1 February 2005 was NZD $3,946,188 instead of NZD $3,961,905 anticipated at the initial drawn down date. This created an unexpected component of NZD $15,716 for the gross income or expenditure in respect of the financial arrangement. The following table presents the unexpected component of the gross income or expenditure over the term of the financial arrangement.

Date	Expected cash NZD	Actual cash NZD	Unexpected income/ expenditure
1-Oct-04	109,090,909	109,090,909	
1-Feb-05	-3,961,905	-3,946,188	-15,716
1-Aug-05	-5,886,259	-,928,144	41,885
1-Feb-06	-5,830,199	-5,981,873	151,674
1-Aug-06	-5,774,673	-6,218,593	443,920
1-Feb-07	-5,719,676	-6,500,328	780,652
1-Aug-07	-5,665,203	-5,845,881	180,678
1-Feb-08	-5,611,249	-6,547,619	936,370
1-Aug-08	-5,557,808	-6,998,940	1,441,131
1-Feb-09	-5,504,877	-5,652,298	147,421
1-Aug-09	-5,452,450	-5,299,786	-152,664
1-Feb-10	-5,400,521	-5,247,813	-152,708
1-Aug-10	-5,349,088	-5,110,996	-238,091
1-Feb-11	-5,298,144	-4,908,280	-389,865
1-Aug-11	-5,247,686	-4,686,391	-561,295
1-Feb-12	-5,197,708	-4,464,487	-733,221
1-Aug-12	-5,148,206	-4,485,727	-662,479
1-Feb-13	-5,099,175	-4,608,939	-490,237
1-Aug-13	-5,050,612	-5,006,321	-44,291
1-Feb-14	-5,002,511	-5,008,854	6,343
1-Aug-14	-4,954,868	-5,008,854	53,986
1-Oct-14	-90,866,409	-92,739,691	1,873,282
Total	-88,488,316		2,616,778

At the first balance date – 31 March 2005

Expected component = 4,646,006 + (4,675,141 × 59/181) = $6,169,947.

Unexpected component = $15,716.

Total gross expenditure = $6,169,947 – $15,716 = $6,154,231.

At the second balance date – 31 March 2006

Expected component = (122/181 × 4,675,141) + 4,623,561 + (4,572,173 × 59/181) = $9,265,138.

Unexpected component = $41,885 + $151,674 = $193,559.

Total gross expenditure = $9,265,138 + $193,559 = $9,458,697.

On 1 June 2006 the corporate borrower decides to switch out of GBP and borrow more USD. For the purpose of calculating the corporate's gross income or expenditure, the GBP tranche is deemed to be repaid and is subject to the base price adjustment in this income year. The spot rate GBP to NZD was 0.3200 on the date of repayment.

The base price adjustment is given in section EH 47 of the Act. It calculates an amount by application of the formula—

consideration – income + expenditure + amount remitted

where—

consideration is the consideration paid or payable to the company less the consideration paid or payable by the company. This is equal to the amount of GBP drawn down less the sum of the interest payments made and the deemed principal repayment amount

= 36 m/.3300 – (1.32m/.3345 + 1.98 m/.3340 + 1.98m/.3310 + 36m/.3200)

= NZD $109,090,909 – NZD $128,356,205

= -NZD $19,265,296

income is all the amounts of gross income derived in previous income years = 0

expenditure is expenditure incurred in previous income years. The gross expenditure for the previous 2 years of the loan facility were—

for the year ended 31 March 1989 = $6,154,231;

for the year ended 31 March 1990 = $9,458,697.

The total gross expenditure is 6,154,231 + 9,458,697 = NZD $15,612,928

amount remitted is the amount of consideration remitted = 0.

The base price adjustment is therefore—

-19,265,296 + 15,612,928 = -NZD $3,652,368.

This amount is gross expenditure of the corporate borrower in this income year in accordance with section EH 47 of the Act.

Example D: Variable rate financial arrangement

This example is similar to Example D in *Determination G26: Variable Rate Financial Arrangements*. This example illustrates how this determination could be applied to a variable rate financial arrangement.

A New Zealand company purchased a USD note with a face value of $10,000 for a term of 3 years at a discount of 10% ($1,000). The interest rate is equal to market interest plus 1% pa, and interest is payable half-yearly in arrears. There are no fees. The interest rate is 10% in the first period after issue.

Assuming that this interest rate holds throughout the term of the notes, the yield to maturity is 14.2% pa, calculated at half-yearly rests. The table below summarises the expected base currency payments and the relevant spot and forward exchange rates.

t	USD Cash	Spot	Fwd (0,t)	US,I	NZ,I
0	-9,000	0.6310	0.6310	0.05	0.04
1	500	0.6455	0.6371	0.05	0.04
2	500	0.6500	0.6432	0.05	0.04
3	500	0.6550	0.6494	0.05	0.04
4	500	0.6570	0.6556	0.05	0.04
5	500	0.6580	0.6619	0.05	0.04
6	10,500	0.6400	0.6683	0.05	0.04
	14.2%				

At the time of entering into the floating arrangement, the New Zealand company needs to make the following calculation:

t	USD cash	Expected cash NZD	Expected income
0	-9,000	-14,263	
1	500	785	868
2	500	777	873
3	500	770	879
4	500	763	885
5	500	755	893
6	10,500	15,712	901
	4,000	5,299	5,299
	14.2%	12.2%	

The base currency payments, calculated on the basis of the initial interest rate (ie 10%), are translated into expected NZD payments on the basis of forward rates available at the time the company entered into the financial arrangement. The expected NZD net amount of NZD $5,299, representing a yield of 12.2%, is spread using the yield to maturity method consistent with *Determination G3*. The expected component of the gross income or expenditure for each half-year period over the term of the arrangement is presented in the final column of the table above.

When payments are subsequently made, the actual NZD payments may differ from the expected NZD payments due to fluctuations in both the interest rates and the exchange rates. The final outcomes are presented in the following table:

t	Actual US,I	Actual cash USD	Expected cash NZD	Actual cash NZD	Unexpected income/ expenditure
0		-9,000	-14,263	-14,263	0
1	0.10	500	785	775	-10
2	0.11	500	777	846	69
3	0.09	500	770	687	-83
4	0.09	500	763	685	-78
5	0.08	500	755	608	-147
6	0.08	10,500	15,712	16,250	538

At the first balance date

There are 2 components to the gross income or expenditure in relation to the floating rate financial arrangement for the New Zealand company. These include—

Expected component = $868 + $873 = $1,741; and

Unexpected component = -$10 + $69 = $59.

The gross income for the first balance date is therefore $1,800.

At the second balance date

The gross income consists of—

Expected component = $879 + $885 = $1,764; and

Unexpected component = -$83 – $78 = -$161.

The gross income for the second balance date is therefore $1,603.

At the final balance date

The New Zealand company has to perform a base price adjustment under section EH 47 of the Act—

consideration – income + expenditure + amount remitted

where—

consideration	is the consideration paid or payable to the company less the consideration paid or payable by the company
	= 775 + 846 + 687 + 685 + 608 + 16,250 - 14,263
	= NZD $5, 588
income	is all the amounts of gross income derived in previous income years
	1,800 + 1,603
	= NZD $3,403
expenditure	is expenditure incurred in previous income years
	= 0
amount remitted	is the amount of consideration remitted
	= 0.

So the base price adjustment is—

consideration – income + expenditure + amount remitted

= 5,588 – 3,403 + 0 + 0

= NZD $2,185.

Since this is a positive amount, it is gross income of the New Zealand company in this income year.

DETERMINATION G14B: FORWARD CONTRACTS FOR FOREIGN EXCHANGE AND COMMODITIES: AN EXPECTED VALUE APPROACH

This determination may be cited as "Determination G14B: Forward contracts for foreign exchange and commodities: an expected value approach".

This determination cancels and replaces Determination G14A: Forward contracts for foreign exchange and commodities: an expected value approach.

1. Explanation (which does not form part of the determination)

What is a forward contract for foreign exchange and commodities?

A forward contract for foreign exchange or commodities is a contract to buy or sell specified amounts of foreign currency or commodities at some future date at a specified contract rate. For example, a forward contract for foreign currency is a contract to buy or sell specified amounts of a currency at a future date at a price fixed (in terms of another currency) at the time the contract is entered into. Each party contracts simultaneously to sell one currency and purchase another currency. The same forward contract can always be viewed as either the sale of one currency or the purchase of the other currency. For example, a person who sells NZD forward against purchase of USD can view the contract as either—

- the forward sale of NZD, or
- the forward purchase of USD.

A forward contract has characteristics that are very similar to a swap contract. In fact, swaps are often structured as a series of forward contracts. If you are a party to a swap, however, you may not apply this determination as swaps are subject to *Determination G27*. The only exception is a swap contract for fixed amounts, to be exchanged at a single fixed date. This type of swap is, in substance, a forward contract. Therefore, if you are a party to this type of forward contract, you have to apply this determination instead of *Determination G27*.

When do you use this determination?

You must use this determination for the 2003–2004 income year and a forward contract for which this determination applies if—

- you are not a member of a group of companies and on or before the day that is the earlier of 31 July 2004 and the end of your accounting period that

corresponds to the 2003–2004 income year, you give to the Commissioner notice in writing that you elect—
(a) to use this determination; and

(b) to use *Determination G9C: Financial arrangements that are denominated in a currency other than New Zealand dollars: an expected value approach*;

- you are a member of a group of companies and, on or before the day that is the earlier of 31 July 2004 and the earliest day that is the end of an accounting period that corresponds to the 2003–2004 income year for a member of the group, the members of the group give to the Commissioner notice in writing of an election—
  (a) to use this determination; and

  (b) to use *Determination G9C: Financial arrangements that are denominated in a currency other than New Zealand dollars: an expected value approach*.

You must use this determination for the 2004–2005 income year and a forward contract for which this determination applies if—

- you entered the forward contract after the date of this determination and were required to make a return of your income or expenditure for the 2003–04 income year on the basis of this determination, *Determination G9B: Financial arrangements that are denominated in a currency other than New Zealand dollars: an expected value approach* or *Determination G14A*;

- you are not a member of a group of companies and, on or before the day that is the later of 31 July 2004 and the 63rd day of your accounting period that corresponds to the 2004–2005 income year, you give to the Commissioner notice in writing that you elect—
  (a) to use this determination; and

  (b) to use *Determination G9C: Financial arrangements that are denominated in a currency other than New Zealand dollars: an expected value approach*;

- you are a member of a group of companies and, on or before the day that is the later of 31 July 2004 and the earliest day that is the 63rd day of an accounting period that corresponds to the 2004–2005 income year for a member of the group, the members of the group give to the Commissioner notice in writing of an election—
  (a) to use this determination; and

  (b) to use *Determination G9C: Financial arrangements that are denominated in a currency other than New Zealand dollars: an expected value approach*.

You must use this determination for an income year beginning after the 2004–2005 income year and a forward contract for which this determination applies if—

- you entered the forward contract after the date of this determination and were required to make a return of your income or expenditure for the 2004–2005 income year on the basis of this determination, *Determination G9B: Financial arrangements that are denominated in a currency other than New Zealand dollars: an expected value approach* or *Determination G14A*;

- you entered the forward contract before the date of this determination and you have made a return of your income or expenditure for an earlier income year and the forward contract on the basis of *Determination G14A* and are required under section 90 or sections 90AC and 90AE of the Tax Administration Act 1994 to make a return for the income year and the financial arrangement under this determination;

- you are not a member of a group of companies and, on or before the day that is the 63rd day of your accounting period that corresponds to the income year, you give to the Commissioner notice in writing that you elect—
  (a) to use this determination; and

  (b) to use *Determination G9C: Financial arrangements that are denominated in a currency other than New Zealand dollars: an expected value approach*;

- you are a member of a group of companies and, on or before the earliest day that is the 63rd day of an accounting period that corresponds to the income year for a member of the group, the members of the group give to the Commissioner notice in writing of an election—
  (a) to use this determination; and

  (b) to use *Determination G9C: Financial arrangements that are denominated in a currency other than New Zealand dollars: an expected value approach*.

You may not use this determination for an income year unless you are required to do so by the above paragraphs.

What methods can be used to calculate income or expenditure under a forward contract for foreign exchange and commodities?

Expected value approach

This determination sets out an expected value approach to calculate gross income or expenditure from a forward contract. This expected value approach can only be used for forward contracts within the scope of this determination, which is narrower than *Determination G14: Forward Contracts for Foreign Exchange and*

Commodities. If you are required to use this determination, you must not use *Determination G14* for any such forward contract, and you must not use *Determination G9A: Financial Arrangements that are Denominated in a Currency or Commodity other than New Zealand Dollars* for any financial arrangement within the scope of *Determination G9C: Financial arrangements that are denominated in a currency other than New Zealand dollars: an expected value approach*.

Mark to spot approach

You may use *Determination G14: Forward Contracts for Foreign Exchange and Commodities* to calculate gross income or expenditure of any forward contract within the scope of this determination if you are not required to use this determination or *Determination G9C: Financial arrangements that are denominated in a currency other than New Zealand dollars: an expected value approach*.

Alternatively, you may use the mark to market method if you satisfy the requirements of section EH 1(6) of the Act or the market valuation method if you satisfy the requirements of section EH 36 of the Act.

You may also use a method allowed by the proviso to section EH 1(6) of the Act or by section EH 38(2) of the Act.

How do I use the method set out in this determination?

Under this method, the gross income or expenditure from a forward contract is the total of an expected component and an unexpected component. A typical forward contract drawn at the forward rate for no consideration, however, has no expected component.

To apply this method to a forward contract for the income year in which you enter the forward contract, you must—

- ignore any offsetting of payments between the parties, so that every amount that would be payable under the forward contract is taken into account under this determination; and
- choose one of the currencies under the forward contract as a base currency; and
- determine the expected component by taking into account all the base currency payments and payment dates in relation to the forward contract when you become a party to the contract, which consist of—
  (a) the base currency value of the payment or receipt, if any, made in consideration of entering into the contract;
  (b) the base currency value of the non-base currency payment to be made under the contract valued at the forward rate;
  (c) the base currency value of the non-base currency payment to be made under the contract valued at the contract rate; and
- convert the expected base currency payments, where the base currency is not NZD, into expected NZD payments on the basis of forward rates available at the time you become a party to the forward contract; and
- spread the expected NZD net amount over the term of the forward contract.

To apply this method for the first time to a forward contract for an income year after the income year in which you enter the forward contract, you must calculate the gross income or expenditure of the forward contract as set out above, except that you must—

- in determining the expected component of the gross income or expenditure, use actual NZD payments up to the income year for which you first use this determination for the forward contract and expected NZD payments for the remaining term of the forward contract; and
- in calculating the expected NZD payments, use the relevant forward rates as at the end of the income year for which you first use this determination for the forward contract.

You must perform the base price adjustment under whichever is appropriate of section EH 4 of the Act and section EH 47 of the Act when a forward contract you are a party to matures or is disposed of. This adjustment contains the unexpected component of the gross income or expenditure of the forward contract.

You must also calculate a transition allowance for a financial arrangement to which you apply the method for the first time for an income year that is after the income year in which you enter the financial arrangement.

How do I elect to use the method outlined in this determination?

Election for 2003–2004 and subsequent income years

If you are not a member of a group of companies, you may elect to use this determination for the 2003–2004 and subsequent income years by giving a notice of election to the Commissioner on or before the day that is the earlier of 31 July 2004 and the day that is the end of your accounting period for the 2003–2004 income year. The notice must be in writing and elect—

- to use this determination; and
- to use *Determination G9C: Financial arrangements that are denominated in a currency other than New Zealand dollars: an expected value approach*.

If you are a member of a group of companies, you may elect to use this determination for the 2003–2004 and subsequent income years by giving, together with all other members of the group, a notice of election to the Commissioner on or before the day that is the earlier of 31 July 2004 and the earliest day that is the end of an accounting period for the 2003–2004 income year for a member of the group. The notice must be in writing and elect—

- to use this determination; and
- to use *Determination G9C: Financial arrangements that are denominated in a currency other than New Zealand dollars: an expected value approach.*

Election for 2004–2005 and subsequent income years

If you are not a member of a group of companies, you may elect to use this determination for the 2004–2005 and subsequent income years by giving a notice of election to the Commissioner on or before the day that is the later of 31 July 2004 and the day that is the 63rd day of your accounting period for the 2004–2005 income year. The notice must be in writing and elect—

- to use this determination; and
- to use *Determination G9C: Financial arrangements that are denominated in a currency other than New Zealand dollars: an expected value approach.*

If you are a member of a group of companies, you may elect to use this determination for the 2004–2005 and subsequent income years by giving, together with all other members of the group, a notice of election to the Commissioner on or before the day that is the later of 31 July 2004 and the earliest day that is the 63rd day of an accounting period for the 2004–2005 income year for a member of the group. The notice must be in writing and elect—

- to use this determination; and
- to use *Determination G9C: Financial arrangements that are denominated in a currency other than New Zealand dollars: an expected value approach.*

Election for income years beginning after 2004–2005 income year

If you are not a member of a group of companies, you may elect to use this determination for an income year beginning after the 2004–2005 income year, and for subsequent income years, by giving a notice of election to the Commissioner on or before the day that is the 63rd day of your accounting period for the income year. The notice must be in writing and elect—

- to use this determination; and
- to use *Determination G9C: Financial arrangements that are denominated in a currency other than New Zealand dollars: an expected value approach.*

If you are a member of a group of companies, you may elect to use this determination for an income year after the 2004–05 income year, and for subsequent income years, by giving, together with all other members of the group, a notice of election to the Commissioner on or before the earliest day that is the 63rd day of an accounting period for the income year for a member of the group. The notice must be in writing and elect—

- to use this determination; and
- to use *Determination G9C: Financial arrangements that are denominated in a currency other than New Zealand dollars: an expected value approach*.

How do I calculate the transitional adjustment?

The transitional adjustment must be made for the first income year for which you are required to use this determination for a forward contract if you entered the forward contract before the income year and you have not been required to apply *Determination G14A* for the forward contract. The calculation is comparable to *Determination G25: Variations in the Terms of a Financial Arrangement*.

The transitional adjustment requires that for the income year of the adjustment you treat as gross income or expenditure the difference between the total amount that would have been gross income or expenditure calculated as described in this determination and the total amount actually recognised over the previous income years.

How is income or expenditure calculated in the year the forward contract matures or is disposed of?

Regardless of which method you choose to use, you must calculate income or expenditure under the base price adjustment in whichever of section EH 4 of the Act and section EH 47 of the Act is applicable to the forward contract.

2. Reference

This determination is made pursuant to section 90(1)(c) and section 90AC(1)(d) of the Tax Administration Act 1994.

3. Scope

(1) This determination applies to the calculation of gross income or expenditure from a forward contract for foreign exchange and commodities.

(2) This determination does not apply to—
  (a) a futures contract;
  (b) a security arrangement;
  (c) a forward contract for foreign exchange and commodities where the forward rates of the currency cannot be determined;
  (d) any forward contracts covered by the following determinations:

  Determination G19: Exchange Traded Option Contracts;

Determination G20: Discounted Value of Amounts Payable in Relation to Trade Credits Denominated in a Foreign Currency;

Determination G21: Discounted Value of Amounts Payable in Relation to Deferred Property Settlements Denominated in a Foreign Currency;

Determination G21A: Agreements for Sale and Purchase of Property Denominated in Foreign Currency: Discounted Value of Amounts Payable;

Determination G27: Swaps;

Determination G29: Agreements for Sale and Purchase of Property Denominated in Foreign Currency: Exchange Rate to Determine the Acquisition Price and Method for Spreading Income and Expenditure;

except as specifically allowed by those determinations.

(3) You must use this determination for an income year for a forward contract that satisfies subparagraphs (1) and (2) above if—

(a) the income year is the 2003–2004 income year and—

(i) you are not a member of a group of companies and make an election, as described in subparagraph (4) below, that applies for the 2003–2004 income year;

(ii) you are a member of a group of companies and the members of the group make an election, as described in subparagraph (4) below, that applies for the 2003–2004 income year;

(b) the income year is after the 2003–2004 income year and—

(i) you are not a member of a group of companies and make an election, as described in subparagraph (4) below, that applies for the income year;

(ii) you are a member of a group of companies and the members of the group make an election, as described in subparagraph (4) below, that applies for the income year;

(iii) you entered the forward contract after the date of this determination and have been required to use this determination, *Determination G9B* or *Determination G14A* for an earlier income year;

(iv) you entered the financial arrangement before the date of this determination and have used *Determination G14A* for an earlier income year and the financial arrangement and are not excluded from the application of this determination for the income year and the financial arrangement by section 90(6) or 90AE of the Tax Administration Act 1994.

(4) An election to use this determination must—

(a) be made in writing to the Commissioner; and

(b) include an election to use *Determination G9C: Financial arrangements that are denominated in a currency other than New Zealand dollars: an expected value approach*; and

(c) if you are not a member of a group of companies, be made—

(i) on or before the day that is the earlier of 31 July 2004 and the end of your accounting period that corresponds to the 2003–2004 income year, if the election is to apply for the 2003–2004 and subsequent income years;

(ii) on or before the day that is the later of 31 July 2004 and the 63rd day of your accounting period that corresponds to the 2004–2005 income year, if the election is to apply for the 2004–2005 and subsequent income years;

(iii) on or before the earliest day that is the 63rd day of your accounting period that corresponds to the income year, if the election is to apply for an income year that is after the 2004–2005 and for subsequent income years; and

(d) if you are a member of a group of companies, be made by all the members of the group and—

(i) on or before the day that is the earlier of 31 July 2004 and the earliest day that is the end of an accounting period that corresponds to the 2003–2004 income year for a member of the group, if the election is to apply for the 2003–2004 and subsequent income years;

(ii) on or before the day that is the later of 31 July 2004 and the earliest day that is the 63rd day of an accounting period that corresponds to the 2004–2005 income year for a member of the group, if the election is to apply for the 2004–2005 and subsequent income years;

(iii) on or before the earliest day that is the 63rd day of an accounting period that corresponds to the income year for a member of the group, if the election is to apply for an income year that is after the 2004–2005 income year and for subsequent income years.

(5) If you must use this determination, you may not use—
   (a) *Determination G14: Forward Contracts for Foreign Exchange and Commodities* to calculate gross income or expenditure of any forward contract that is within subparagraphs (1) and (2) above;
   (b) *Determination G9A: Financial Arrangements that are Denominated in a Currency or Commodity other than New Zealand Dollars* to calculate gross income or expenditure of any financial arrangement that is within the scope of *Determination G9C: Financial arrangements that are denominated in a currency other than New Zealand dollars: an expected value approach*.

(**Note**: A determination to which *Determination G14B* refers may be changed or rescinded by a new determination made by the Commissioner. In such a case, a reference to the old determination is extended to the new determination.)

4. Principle

(1) If you are a party to a forward contract to which this determination applies, the gross income or expenditure in respect of the forward contract is calculated by taking into account all amounts arising from the fluctuations of exchange rates or commodity prices.

(2) The gross income or expenditure from the forward contract is the total of an expected component and the unexpected component.

(3) If you must apply this determination to a forward contract for the income year in which you enter the forward contract, you must measure the expected component as at the time you enter the forward contract.

(4) To measure the expected component you must convert the base currency payments into expected NZD payments on the basis of forward rates as at the time you become a party to the forward contract and spread the expected NZD net amount over the term of the contract.

(5) If you must apply this determination for the first time to a forward contract for an income year that is after the income year in which you enter the forward contract, and you have not applied *Determination G14A* for the forward contract, you must measure the expected component as at the end of the income year. You must follow the principle set out above by calculating the expected NZD net amount using actual NZD payments up to the end of the income year in which you first apply the determination and the forward rates as at the end of that income year.

(6) You must recognise the unexpected component for a forward contract by performing the base price adjustment that is required under whichever is applicable of section EH 4 of the Act and section EH 45 of the Act.

Transitional adjustment

(7) For the first income year for which you must use this determination, you must perform the transitional adjustment calculation to calculate gross income or expenditure for all forward contracts—
   (a) that you entered before the income year; and
   (b) for which you have not been required to use *Determination G14A*.

(8) This adjustment ensures that the gross income or expenditure up to the end of the income year in which you first use this determination is equal to that that would have been returned if the actual NZD payments and the forward rates, as described in subparagraph (4), were known and this determination had been used since you became a party to the forward contract.

5. Interpretation

(1) In this determination, a reference to the **Act** is a reference to the Income Tax Act 1994.

(2) In this determination—

base currency in relation to a person and a forward contract, means the currency under the forward contract which is adopted by the person as a reference currency for the purposes of this determination

commencement date of a forward contract means the date on which the contract was entered into, or the date on which it was acquired, if later

contract rate in relation to a forward contract means the price of one currency expressed in terms of the other currency under the forward contract

covered interest parity means the proposition that the differential between forward and spot exchange rates is equal to the interest differentials. That is, the forward rate for a foreign currency exchange at time t for 1 period ahead is equivalent to the spot rate at time t, S_t, multiplied by 1 plus the foreign interest rate, i_f, divided by 1 plus the domestic interest rate, i_d. Forward rates at time t for n periods, $Fwd_{t,n}$, can thus be derived based on the principle of covered interest parity as—

$$Fwd_{t,n} = S_t \times \frac{(1 + i_f)^n}{(1 + i_d)^n}$$

currency includes any commodity used as a medium of exchange or account, whether in general use or for the purpose of an arrangement

exchange rate means the price of 1 currency expressed in another currency

forward rate means the exchange rate for a forward contract as defined in *Determination G6D: Foreign Currency Rates* or the forward exchange rate calculated using the principle of covered interest parity or other methods that are commercially acceptable. In the case where the base currency is a commodity, the forward rate is the future value of the commodity (in NZD)

future value in relation to a commodity and a future date means the value of the commodity at the future date, on a given date, derived from any commercially-acceptable, market-based method of valuation

NZD means the currency of New Zealand

non-base currency means the currency under a forward contract that is not the base currency

spot contract means a contract for the sale or purchase of a currency for delivery in 2 business days

spot rate means the exchange rate for a spot contract as defined in *Determination G6D: Foreign Currency Rates* or in the case of a commodity, the spot value (in NZD) of the commodity

spot value in relation to a commodity and a day means the value of the commodity on that day derived from any commercially-acceptable method of valuation

USD means the currency of the United States of America.

(3) All other terms used have the meaning given to them for the purpose of the Act.

6. Method

(1) Your gross income or expenditure in an income year from a forward contract under this determination is the total of—

(a) the expected component, calculated in accordance with subparagraphs (2) to (8); and

(b) the unexpected component, calculated in accordance with subparagraph (9).

(2) To calculate the income or expenditure in relation to a forward contract, you must first nominate a base currency.

(3) If the terms of the forward contract provide for the netting off or offsetting of any amounts payable to or by one party to the forward contract with any amounts payable to or by the other party to the forward contract, you must ignore such netting off or offsetting for the purpose of this determination.

(4) If the first income year for which you are required to apply this determination to a forward contract is the income year in which you become a party to the forward contract, you must calculate the expected component for each income year of the remaining term of the forward contract as at the time you become a party to the forward contract. The expected component is calculated by first taking into account all base currency payments in relation to the forward contract. The base currency payments of a forward contract consist of—

(a) the base currency value of the payment or receipt, if any, made in consideration of entering into the forward contract;

(b) the base currency value of the non-base currency payment to be made under the contract valued at the forward rate;

(c) the base currency value of the non-base currency payment to be made under the contract valued at the contract rate.

(5) You must convert the base currency payments into NZD using forward rates as at the time you become a party to the forward contract if the base currency is not NZD.

(6) The expected NZD net amount is the difference between items (b) and (c) in subparagraph (4), adjusted for any amount as described in item (a). You must spread the expected NZD net amount using the yield to maturity method consistent with *Determination G3* and, where necessary, allocate it to the income year on the basis of *Determination G1A*. This will give the expected component for each income year.

(7) You must use the straight-line method to spread the expected NZD net amount of a forward contract that has been written for no consideration at a rate other than the forward rate.

(8) If the first income year for which you are required to apply this determination to a forward contract is after the income year in which you entered the forward contract, and you have not been required to use *Determination G14A* for the forward contract, you must follow the method set out in subparagraphs (1) to (7) to calculate gross income or expenditure of the forward contract, except that—

(a) the NZD net amount to be spread under subparagraph (6) consists of—

(i) actual NZD payments that have occurred since you became a party to the forward contract until the end of the first income year for which you must use this determination;

(ii) expected NZD payments in the remaining term of the forward contract; and

(b) the expected NZD payments in the remaining term of the forward contract must be calculated on the basis of the forward rates available at the end of the first income year for which you must use this determination for the forward contract.

(9) The unexpected component is the difference between the actual NZD value of the payments during the year and the expected NZD value of those payments as calculated under subparagraph (5). You need not calculate the unexpected component separately as it is part of the base price adjustment required under whichever is applicable of section EH 4 of the Act and section EH 45 of the Act.

Transitional adjustment for existing forward contracts for foreign exchange and commodities

(10) You must perform a transitional adjustment calculation for the first income year for which you must use this determination to calculate gross income or expenditure of any forward contract, if you entered the forward contract before the income year and have not been required to use *Determination G14A* for the forward contract. You must perform the transitional adjustment calculation for such forward contract in accordance with the following formula:

$$a - b - c + d$$

where—

a is the sum of all amounts that would have been income in respect of the forward contract from the time it was entered until the end of the income year, if this determination had applied from the time you became a party to the forward contract

b is the sum of all amounts that would have been expenditure in respect of the forward contract from the time it was entered until the end of the income year, if this determination had applied from the time you became a party to the forward contract

c is the sum of all income in respect of the forward contract since it was acquired until the end of the previous income year

d is the sum of all expenditure in respect of the forward contract since it was acquired until the end of the previous income year.

A positive net amount is gross income while a negative net amount is gross expenditure in the first income year for which you must use this determination.

7. Examples

(1) A New Zealand corporate borrower enters into a long-term forward foreign exchange contract to buy USD $1,000,000 against delivery of NZD in 2 years' time. The contract was entered into on 30 April 2005 for no consideration and the corporate borrower has a balance date of 30 June. The contract rate is 0.5919 USD to 1 NZD, so settlement will require delivery of NZD $1,689,475. The corporate chooses NZD as the base currency for this contract.

(2) At the time the New Zealand corporate becomes a party to the forward contract, the expected NZD net amount is zero and so the expected component of the gross income or expenditure from the forward contract is zero. The New Zealand corporate will recognise the unexpected component of the gross income or expenditure from the forward contract when performing the base price adjustment under section EH 47 of the Act.

Further examples are provided in the schedule.

Signed on the 3rd day of June 2004.

Robin Oliver
General Manager, Policy

Schedule: Further examples

Note: In each example involving a base price adjustment, the base price adjustment is calculated on the assumption that the forward contract is subject to Division 2 of Part EH of the Act. The details of the calculation would differ for a forward contract that was subject to Division 1 of Part EH of the Act.

For the purpose of examples A to C assume that the spot rates and the forward rates for USD/NZD on the relevant dates are as follows:

Date	Actual spot	CIP: Fwd (0,t)	CIP: Fwd (1,t)	CIP: Fwd (2,t)	Expected US,I	Expected NZ,I
30-Apr-04	0.6350	0.6350			0.04	0.06
30-Apr-05	0.6149	0.6230	0.6149		0.04	0.06
30-Apr-06	0.5750	0.6113	0.6033	0.5750	0.04	0.06
30-Apr-07	0.5570	0.5997	0.5919	0.5642	0.04	0.06

The forward exchange rates are derived on the principle of covered interest parity (CIP) using the expected interest rates in the United States of America (US,I) and the expected domestic interest rates (NZ,I). Fwd (0,t) represents the forward rates at 30 April 2004 out to period t, while Fwd (1,t) and Fwd (2,t) represent the forward rates at 30 April 2005 and 30 April 2006, respectively, out to period t. For convenience in these examples when calculating the base price adjustment, the same buy/sell spot rates have been used at date of delivery. In practice this would not normally be the case.

Example A: Seller of base currency (NZD); contract rate is equal to market rate

A New Zealand corporate borrower enters into a long-term forward foreign exchange contract to buy USD $1,000,000 against delivery of NZD in 2 years' time. The contract was entered into on 30 April 2005 for no consideration and the corporate borrower has a balance date of 30 June. The contract rate is 0.5919 USD to 1 NZD, so settlement will require delivery of NZD $1,689,475. The corporate chooses NZD as the base currency for this contract.

At the time the contract was entered into – 30 April 2005

The expected base currency payments in relation to the forward contract consist of—

- the base currency value of the payment or receipt made in consideration of entering into the forward contract = 0;
- the base currency value of the non-base currency payment to be made under the contract valued at the forward rate = NZD $1,689,475;
- the base currency value of the non-base currency payment to be made under the contract valued at the contract rate = NZD $1,689,475.

Since the forward contract was entered into at the forward rate for no consideration, the expected NZD net amount is nil. So there is no expected component to be spread under the accrual rules.

At the final balance date – 30 June 2007

In the 30 June 2007 income year, the base price adjustment given in section EH 47 of the Act is calculated by applying the formula—

consideration – income + expenditure + amount remitted

where—

consideration is the consideration paid or payable to the company less the consideration paid or payable by the company

= 1,000,000/0.557 – 1,689,475

= 1,795,332 – 1,689,475

= NZD $105,857

income is all the amounts of gross income derived in previous income years

= 0

expenditure is expenditure incurred in previous income years

= 0

amount remitted is the amount of consideration remitted

= 0.

Therefore, the base price adjustment = $105,857 and since this is positive, the amount of NZD $105,857 is gross income of the New Zealand corporate for the 30 June 2007 income year.

Example B: Seller of base currency (NZD); contract rate is equal to the market rate

A New Zealand corporate borrower enters into a long-term forward foreign exchange contract to buy USD $1,000,000 against delivery of NZD in 3 years' time. The contract was entered into on 30 April 2004 for no consideration and the corporate borrower has a balance date of 30 June. The contract rate is 0.5997 USD to 1 NZD, so settlement will require delivery of NZD $1,667,416. The corporate chooses NZD as the base currency for this contract.

Assume that the New Zealand corporate has not been using *Determination G14A* and has been using an alternative method to calculate the income or expenditure of the forward contract in the 2003–04 income year. In fact, the corporate has recognised NZD $32,982 as gross income in respect of the forward contract for the year ending 30 June 2004. However, the corporate has elected to use this determination for the 2004–05 and subsequent income years.

Further, assume that the forward rate on 30 June 2005 out to 30 April 2007, the delivery date of the forward contract, is 0.5919. Therefore, the market rate for the delivery of USD $1,000,000 on 30 April 2007 is NZD $1,689,475. Given the contract rate of 0.5997 for the delivery of USD $1,000,000 there is an expected NZD net amount of NZD $22,059. Using this determination, the expected NZD net amount should be spread on a straight line basis over the term of the forward contract.

The transitional adjustment in the 2004–05 income year – 30 June 2005

Using a straight line method to spread the expected NZD net amount of NZD $22,059, the gross income in relation to the forward contract for the year ending 2004 and 2005 should have been NZD $1,226 and NZD $7,353, respectively.

Therefore the transitional adjustment is—

a – b – c + d

where—

a the sum of all amounts that would have been income from the time the corporate become a party to the forward contract until the end of the income year
= 1,226 + 7,353

= $8,579

b the sum of all amounts that would have been expenditure from the time the corporate become a party to the forward contract until the end of the income year
= 0

c the sum of all income in respect of the forward contract since it was acquired until the end of the previous income year
= $32,982

d the sum of all expenditure in respect of the forward contract since it was acquired until the end of the previous income year
= 0.

The net amount of –NZD $24,403 is gross expenditure in the 2004–2005 income year.

At the final balance date – 30 June 2007

In the 30 June 2007 income year, the base price adjustment given in section EH 47 of the Act is calculated by applying the formula—

consideration – income + expenditure + amount remitted

where—

consideration	is the consideration paid or payable to the company less the consideration paid or payable by the company
	= 1,000,000/0.557 – 1,667,416
	= 1,795,332 – 1,667,416
	= NZD $127,916
income	is all the amounts of gross income derived in previous income years
	= 32,982 + 7,353
	= NZD $40,335
expenditure	is expenditure incurred in previous income years
	= NZD $24,403
amount remitted	is the amount of consideration remitted
	= 0.

Therefore, the base price adjustment = $127,916 – $40,335 + $24,403 + 0 = $111,984 and since this is positive, the amount of NZD $111,984 is gross income of the New Zealand corporate for the 30 June 2007 income year.

Example C: Seller of base currency (NZD); contract rate is not equal to the market rate

A New Zealand corporate borrower enters into a long-term forward foreign exchange contract to buy USD $1,000,000 against delivery of NZD in 2 years' time. The contract was entered into on 30 April 2005 and the corporate borrower has a balance date of 30 June. The contract rate is 0.5997 USD to 1 NZD, so settlement will require delivery of NZD $1,667,416. For the purpose of this example assume that the corporate borrower paid NZD $10,000 to enter into this forward contract. (This could be the same forward contract as in the previous example where the forward contract was sold on 30 April 2005.) The corporate chooses NZD as the base currency for this contract.

At the time the contract was entered into – 30 April 2005

The forward rate in this case is 0.5919 USD to 1 NZD, which is different from the contract rate of 0.5997 USD to 1 NZD. The expected settlement on the commitment to purchase USD $1,000,000 at 30 April 2007 is, therefore, NZD $1,689,475. The payment made in acquiring the forward contract was NZD $10,000. Thus, the expected base currency payments in this example consist of—

- the base currency value of the payment or receipt made in consideration of entering into the forward contract = NZD $10,000;
- the base currency value of the non-base currency payment to be made under the contract valued at the forward rate = NZD $1,689,475;
- the base currency value of the non-base currency payment to be made under the contract valued at the contract rate = NZD $1,667,416.

So, the expected NZD net amount from the forward contract is NZD $12,059 (i.e. the difference between the commitments under the forward contract measured at the contract rate (NZD $1,667,416) and the commitments under the forward contract measured at the forward rate (NZD $1,689,475) less the payment made to acquire the forward contract).

The payments in relation to the forward contract are summarised in the table below. The expected NZD net amount is spread using the yield to maturity method recommended in *Determination G3* and allocated to the income year on a daily basis consistent with *Determination G1A*.

Date	Expected cash (NZD)	Contract cash (NZD)	Expected cash (NZD)	Expected income
30-Apr-05	0	0	-10,000	
30-Apr-06	0	0	0	4,852
30-Apr-07	1,689,475	1,667,416	22,059	7,207
Total			12,059	12,059
YTM			49%	

At the first balance date – 30 June 2005

Expected component = (61/365 × $4,852) = $811.

Unexpected component = 0.

The amount of $811 is gross income at the first balance date.

At the second balance date – 30 June 2006

Expected component = (61/365 × $7,207) + (304/365 × $4,852) = $1,204 + $4,041 = $5,245.

Unexpected component = 0.

The amount of $5,245 is gross income at the second balance date.

At the final balance date – 30 June 2007

In the 30 June 2007 income year, the base price adjustment given in section EH 47 of the Act is calculated by applying the formula—

consideration – income + expenditure + amount remitted

where—

consideration is the consideration paid or payable to the company less the consideration paid or payable by the company

= 1,000,000/0.557 – 1,667,416 – 10,000

= 1,795,332 – 1,677,416

= NZD $117,916

income is all the amounts of gross income derived in previous income years

= 811 + 5,245

= NZD $6,056

expenditure is expenditure incurred in previous income years

= 0

amount remitted is the amount of consideration remitted

= 0.

Therefore, the base price adjustment = $117,916 – $6,056 + 0 + 0 = $111,860 and since this is positive, the amount of NZD $111,860 is gross income of the New Zealand corporate for the 30 June 2007 income year.

Example D: Purchaser of base currency (USD); contract rate is not equal to the market rate

Assuming that in the previous example, the corporate chooses USD as the base currency for the forward contract.

At the time the contract was entered into – 30 April 2005

Since the base currency is USD, the base currency payments expected at the commencement date is—

- the base currency value of the payment or receipt made in consideration of entering into the forward contract = NZD $10,000 × 0.6149 = USD $6,149;

- the base currency value of the non-base currency payment to be made under the contract valued at the forward rate = NZD $1,667,416 × 0.5919 = USD $986,944;
- the base currency value of the non-base currency payment to be made under the contract valued at the contract rate = NZD $1,667,416 × 0.5997 = USD $1,000,000.

The expected base currency payments (summarised in column 4 of the table below) are converted into NZD using the relevant forward rates. The expected NZD net amount of NZD $12,057 is then spread over the term of the forward contract using the yield to maturity method recommended in *Determination G3* and allocated to the income year on a daily basis consistent with *Determination G1A*.

Date	Expected cash (USD)	Contract cash (USD)	Expected cash (USD)	Expected cash (NZD)	Expected income
30-Apr-05	0	0	-6,149	-10,000	
30-Apr-06	0	0		0	4,852
30-Apr-07	986,944	1,000,000	13,056	22,057	7,206
Total			6,907	12,057	12,057
YTM			46%	49%	

At the first balance date – 30 June 2005

Expected component = (61/365 × $4,852) = $811.

Unexpected component = 0.

The amount of $811 is gross income at the first balance date.

At the second balance date – 30 June 2006

Expected component = (61/365 × $7,206) + (304/365 × $4,852) = $1,204 + $4,041 = $5,245.

Unexpected component = 0.

The amount of $5,245 is gross income at the second balance date.

At the final balance date – 30 June 2007

In the 30 June 2007 income year, the base price adjustment given in section EH 47 is calculated by applying the formula—

consideration – income + expenditure + amount remitted

where—

consideration is the consideration paid or payable to the company less the consideration paid or payable by the company

= 1,000,000/0.557 – 1,667,416 – 10,000

= 1,795,332 – 1,677,416

= NZD $117,916

income is all the amounts of gross income derived in previous income years

= 811 + 5,245

= NZD $6,056

expenditure is expenditure incurred in previous income years

= 0

amount remitted is the amount of consideration remitted

= 0.

Therefore, the base price adjustment = $117,916 – $6,056 = $111,860 and since this is positive, the amount of NZD $111,860 is gross income of the New Zealand corporate for the 30 June 2007 income year.

Example E: Forward contract to purchase commodity for USD at non-market rate with a corresponding forward contract in foreign exchange in market rate

For the purpose of this example, assume that the forward rates for USD/NZD are as summarised in the following table. These forward exchange rates are derived on the principle of covered interest parity (CIP). Fwd (0,t) represents the forward rates at 30 June 2004 out to period t while Fwd (1,t) and Fwd (2,t) represent the forward rates at 30 June 2005 and 30 June 2006, respectively, out to period t.

Date	Actual spot	CIP: Fwd (0,t)	CIP: Fwd (l,t)	CIP: Fwd (2,t)	Expected US,I	NZ,I Expected
30-Jun-04	0.6350	0.6350			0.04	0.06
30-Jun-05	0.6149	0.6230	0.6149		0.04	0.06
30-Jun-06	0.5750	0.6113	0.6033	0.5750	0.04	0.06
30-Jun-07	0.5570	0.5997	0.5919	0.5642	0.04	0.06

The spot and forward rates per barrel of crude oil (in USD) are summarised in the following table. For example, the market price for a barrel of crude oil was USD $19.2 per barrel on 30 June 2004 while the forward price out to 30 June 2007 was USD $21 per barrel.

Date	Actual spot	Fwd (0,t)	Fwd (1,t)	Fwd (2,t)
30-Jun-04	19.2	19.2000		
30-Jun-05	19.6	20.2000	19.6000	
30-Jun-06	21.1	21.8000	22.1000	21.1000
30-Jun-07	22	21.0000	22.8000	22.1000

A New Zealand company enters into 2 forward contracts simultaneously on 30 June 2004. The first forward contract secures the supply of 10,000 barrels of crude oil. This forward contract is to be cash settled on 30 June 2007, at USD $20 per barrel. The second forward contract was entered into for the purchase of USD $200,000 in exchange for the delivery of NZD at a contract rate of 0.5997. The second forward contract is to be settled on 30 June 2007. For the purpose of this example assume that the corporate chooses USD as the base currency for both contracts.

At the time the forward contracts were entered into – 30 June 2004

The forward contract for the supply of crude oil was entered into at a price below the market rate. (This may be because the supplier is expecting excess supplies that have not been factored into the market prices yet.) The contract rate of $20 is lower than the forward rate of $21. As a result, gains are expected from the forward contract. The expected base currency payments include—

- the base currency value of the payment or receipt made in consideration of entering into the forward contract = 0;
- the base currency value of the non-base currency payment to be made under the contract valued at the forward rate = 10,000 × $21 = USD $210,000;
- the base currency value of the non-base currency payment to be made under the contract valued at the contract rate = 10,000 × $20 = USD $200,000.

The expected base currency payments are converted at the forward rate of 0.5997 USD/NZD and the expected NZD net amount is spread under the accrual rules over the term of the forward contract. As the company did not pay anything to enter into the forward contract, the gains cannot be spread using the yield to maturity method. Therefore, the straight-line method will be adopted to spread the expected gains.

The forward contract for the foreign exchange was entered into at the forward rate. As such, there are no expected gains or losses to be spread under the accrual rules (see Example A).

At the first and second balance date – 30 June 2005 and 30 June 2006

For the forward contract for crude oil—

Expected component = 1/3 ($10,000/0.5997) = $5,558.

Unexpected component = 0.

The amount of $5,558 is gross income at the first and second balance date.

At the final balance date – 30 June 2007

On the 30 June 2007 balance date, the forward contract for the supply of crude oil would have been cash settled at the contract price of USD $20 per barrel. The market price per barrel of crude oil on the delivery date is USD $22. The spot exchange rate on the delivery date is 0.557 USD/NZD.

The base price adjustment given in section EH 47 of the Act in relation to the forward contract for the supply of crude oil is calculated by applying the formula—

consideration – income + expenditure + amount remitted

where—

consideration is the consideration paid or payable to the company less the consideration paid or payable by the company

= 220,000/0.557 - 200,000/0.557

= 394,973 - 359,066

= NZD $35,807

income is all the amounts of gross income derived in previous income years

= 5,558 + 5,558

= NZD $11,116

expenditure is expenditure incurred in previous income years

= 0

amount remitted is the amount of consideration remitted

= 0.

Therefore, the base price adjustment = $35,807 – $11,116 = $24,791 and since this is positive, the amount is gross income of the New Zealand company for the 30 June 2007 income year.

The forward contract for the foreign exchange is also settled on 30 June 2007. In the 30 June 2007 income year, the base price adjustment given in section EH 47 of the Act is calculated by applying the formula—

consideration – income + expenditure + amount remitted

where—

consideration is the consideration paid or payable to the company less the consideration paid or payable by the company

= 200,000/0.557 – 200,000/0.5997

= 359,066 – 333,500

= NZD $25,566

income is all the amounts of gross income derived in previous income years

= 0

expenditure is expenditure incurred in previous income years

= 0

amount remitted is the amount of consideration remitted

= 0.

Therefore, the base price adjustment = $25,566 and since this is positive, the amount is gross income of the New Zealand company for the 30 June 2007 income year.

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

The prescribed rate of interest used to calculate fringe benefit tax on low-interest, employment-related loans has increased from 7.30% to 7.50% for the quarter beginning 1 July 2004.

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 April 2004.

The new rate was approved by Order in Council on 24 May 2004. *Income Tax (Fringe Benefit Tax, Interest on Loans) Amendment Regulations (No 2) 2004.*

REGULAR FEATURES

DUE DATES REMINDER

July 2004

7 Provisional tax instalments due

For people and organisations with a March balance date

20 Employer deductions

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

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

30 GST return and payment due

August 2004

20 Employer deductions

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

31 GST return and payment due

These dates are taken from Inland Revenue's *Smart business tax due date calendar 2004–2005*
The calendar shows the due dates for small employers only—less than $100,000 PAYE and SSCWT deductions per annum.

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