TAX INFORMATION BULLETIN

Vol 16, No 6
July 2004

CONTENTS

Get your TIB sooner on the internet 2

This month's opportunity for you to comment 3

Binding rulings

Product ruling – BR PRD 04/06 4

New legislation

Taxation (Working for Families) Act 2004 7

Legal decisions – case notes

Jurisdiction of the Taxation Review Authority
TRA 020/04 13

Applications for leave to bring proceedings out of time and summary judgment
GAR Palmer v CIR 13

Availability of input tax credits
Ch'elle Properties (NZ) Ltd v CIR 14

Fraudulent and wilfully misleading
TRA 037/2000 16

Operational statement

Income treatment of certain expenditures on conversion of land from one farming or agricultural purpose to another 18

Questions we've been asked

Do the statutory time-bar provisions apply to shortfall penalties? 31

GST group registration of trusts 32

Rewrite advisory panel

Statement setting out the process for resolving potential unintended changes in the Income Tax Act 2004

Panel Statement – RAP 001 35

Regular features

Due dates reminder 40

Your chance to comment on draft taxation items before they are finalised 42

This TIB has no appendix

Inland Revenue
Te Tari Taake

ISSN 0114–7161

GET YOUR TIB SOONER ON THE INTERNET

This *Tax Information Bulletin* is also available on the internet in PDF. Our website is at **www.ird.govt.nz**

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

If you prefer to get the *TIB* from our website and no longer need a paper copy, please let us know so we can take you off our mailing list. You can do this by completing the form at the back of this TIB, or by emailing us at **IRDTIB@datamail.co.nz** with your name and details.

THIS MONTH'S OPPORTUNITY FOR YOU TO COMMENT

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

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

The following draft item is available for review/comment this month, having a deadline of 31 August 2004.

Ref.	**Draft type**	**Description**
ED0064	Standard practice statement	Late filing penalty

Please see page 42 for details on how to obtain a copy.

BINDING RULINGS

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

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

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

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

PRODUCT RULING – BR PRD 04/06

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

Name of the person who applied for the Ruling

This Ruling has been applied for by The New Zealand Guardian Trust Company Limited as Trustee for the NZGT30 Fund ("the Fund").

Taxation Laws

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

This Ruling applies in respect of:

- Section CF 2(3)
- Section CF 2(3A)
- Subpart LE
- Section CF 3(1)(b)
- Section HH 3
- Section GB 1(3), and
- Section BG 1.

The Arrangement to which this Ruling applies

The Arrangement is the establishment and continued operation of the Fund, pursuant to the Deed of Trust dated 5 September 1996 and Deeds of Amendment dated 15 September 2000 and 26 June 2001, which acts as a specialist investment fund to hold a portfolio of shares and other securities that match the composition and weighting of the NZSE30 Capital Share Price Index ("the Index").

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

1. The Trustee and Manager of the Fund is The New Zealand Guardian Trust Company Limited ("the Trustee" and "the Fund Manager"). It is registered as a trustee company under the Trustee Companies Act 1967. The Fund has been established under the Trustee Companies Act 1967 and meets the definition of "group investment fund" contained in section OB 1.
2. The Investment Manager of the Fund is New Zealand Guardian Trust Funds Management Limited ("the Investment Manager"). The Investment Manager was appointed to invest and manage various funds, including the NZGT30 Fund, by an Investment Management Agreement dated 16 August 2000.
3. The Fund invests in securities of those companies that make up the index formerly known as the NZSE30 Capital Share Price Index ("the Index"). The Index provides a measure of price trends of New Zealand's top thirty listed companies and was chosen for its ability to best reflect the shares that are able to be purchased by members of the public on the New Zealand Stock Exchange ("NZSX").
4. The beneficial interest in the Fund is divided into units. Each unit confers an undivided part or share in the beneficial interest of the Fund. Income of the Fund is distributed to unit holders twice a year.
5. The Fund has both "category A units" and "category B units". Category B units are those units which are acquired with funds from "designated sources" as defined in section HE 2(3). As the majority of the investments in the Fund are not from "designated sources", most of the units in the Fund are category A units. All of the units in the Fund are subject to the same rules regarding income distribution and redemption of units.

6. The Trustee receives subscriptions from each investor, with a minimum value of $1,000, with further investments being in multiples of $100. The Trustee also receives redemption requests, of a minimum number of 100 units per investor. On a valuation day subscriptions and redemptions of units are netted off. The Trustee will then purchase securities and issue new units, if the subscriptions exceed the redemptions, or sell securities and cancel units, if the redemptions exceed the subscriptions. The valuation day is defined in clause 1 of the Trust Deed as the close of business on Thursday of each week, or, if any such date is not a business day, the immediately preceding business day.

7. The Fund Manager may also purchase units from unit holders, when unit holders wish to redeem their units. The Fund Manager may use this power only when the Fund does not have enough funds in the cash pool, and is unable to sell sufficient securities in order to redeem the units requested. To date, the Fund Manager has not utilised this power.

8. Clause 6.9 of the Trust Deed enables the Fund to suspend unit redemptions. The power to suspend unit redemptions is used in exceptional circumstances, being:

   - where a material adverse change in the financial markets occurs, namely, a breakdown in liquidity caused by an act of God, or a system failure, or
   - if there is a fundamental breakdown in the functioning of financial markets, namely, closure of the NZSX or a collapse of the market resulting in a lack of liquidity in the Fund's securities.

   Where it is necessary to suspend redemption of units, the suspension will be for a maximum period of three business days, unless the exceptional circumstances giving rise to the need to suspend are beyond the control of the Trustee and the Investment Manager, in which case the suspension shall only be for such a period as is strictly necessary for the Fund and or the Investment Manager to recover from the event.

9. This Ruling does not consider the application of sections CD 3 or CD 4 to the disposal of units by any particular unit holder.

10. The Applicant has confirmed that all aspects of the previous rulings (BR Prv 01/49 and BR Prd 01/17), relating to the Fund, have been complied with except for the statement that:

    > With respect to the Private Ruling BR Prv 01/49 at page 7(c), I advise that we have promptly realigned securities weightings to the NZSX30 Capital Index upon formal advice from the Index provider. There are occasionally delays between NZSX media announcements of changes and actual effective dates of changes. Our record of portfolio tracking error supports our best efforts to adhere to the conditions as required by the Commissioner for the actual portfolio construction relative to the NZSE30 Capital Index. (letter of 17 March 2004 from Anthony Harland of NZGT Funds Management).

11. There has been no change to the Trust Deed of the Fund (except for the noted Deeds of Amendment).

Conditions stipulated by the Commissioner

This Ruling is made subject to the following conditions:

a) All units redeemed by the Fund will be redeemed in whole and not in part.

b) The units are not non-participating redeemable shares as that term is defined in section CF 3(14).

c) Any redemption of units will not be part of a pro-rata cancellation as that term is defined in section CF 3(14).

d) The units will not be quoted on the official list of any recognised exchange as that term is defined in section OB 1.

e) The units are issued on such terms that their redemption is subject to the reverse ordering rule as stated in section CF 3(1)(b)(iv)(B).

f) All distributions received by the Fund will be paid out to unit holders net of any expenses incurred by the Fund.

g) The Fund Manager has the power to purchase units from unit holders, when unit holders wish to redeem their units. The Fund Manager may use this power only when the Fund does not have enough funds in the cash pool, and is unable to sell sufficient securities in order to redeem the units requested.

h) There is no agreement, arrangement or understanding in place between the Fund, the Trustee, the Fund Manager or the Investment Manager (or any person associated with the Fund, the Trustee, the Fund Manager or the Investment Manager) and any unit holder (or any person associated with any unit holder) which directly or indirectly has a purpose or effect of the redemption or disposition of any of a unit holder's units occurring in substitution for or instead of one or more distributions from the Fund.

i) The Fund is a qualifying trust as that term is defined in section OB 1.

How the Taxation Laws apply to the Arrangement

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

- The distribution of category A income to category A unit holders will be treated as a "dividend" pursuant to section CF 2(3).
- In respect of payments made to category A unit holders, section CF 2(3A) will treat the Fund as if it were a company for the purposes of subpart LE of the Act.
- The amount paid to category A unit holders on the redemption of their units will be excluded from the definition of dividend by section CF 3(1)(b) to the extent that the amount does not exceed the available subscribed capital per share cancelled.
- Section GB 1(3) does not apply to the sale of category A units to the Fund Manager by category A unit holders.
- In the absence of other factors relating to the circumstances of any particular category A unit holder, any gain on the sale of the category A units to the Fund Manager does not of itself give rise to the application of section BG 1.
- Any distribution of category B income to category B unit holders is included within the definition of "beneficiary income" as defined in section OB 1, and is included in the gross income of the unit holder under section HH 3(1).
- Under section HH 3(2) the Trustee is liable, as agent for the unit holder, to deduct tax from distributions of category B income made to unit holders at the unit holders' marginal tax rate.
- The amount paid to category B unit holders on the redemption of units is not gross income to the unit holders under section HH 3(5), to the extent that it does not include any "beneficiary income".
- In the absence of other factors relating to the circumstances of any particular category B unit holder, any gain on the sale of the category B units to the Fund Manager does not of itself give rise to the application of section BG 1.

The period or income year for which this Ruling applies

This Ruling will apply for the period 1 July 2004 to 30 June 2007.

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

Martin Smith
General Manager (Adjudication & Rulings)

NEW LEGISLATION

TAXATION (WORKING FOR FAMILIES) ACT 2004

INTRODUCTION

The Taxation (Working for Families) Act was introduced as the Future Directions (Working for Families) Bill as part of this year's Budget and enacted on 3 June 2004. It amends the Income Tax Act 2004 and the Tax Administration Act 1994 and makes a minor consequential change to the Child Support Act 1991.

The Working for Families package has four key components:

- increasing family incomes and making work pay
- more help for housing costs
- more help with childcare costs, and
- improvements to the delivery of family income assistance.

This item explains the changes in the Taxation (Working for Families) Act that relate to part KD of the Income Tax Act 2004 and any relevant amendments to the Tax Administration Act 1994. The package includes changes to the rates of family support, the introduction of a new in-work payment and the phasing out of the child tax credit. The changes will be introduced over three years, from 1 April 2005 to 1 April 2007.

Key features

Family support

The rates for family support increase by $25 for the first child and $15 for each subsequent child on 1 April 2005. The threshold at which family income assistance (being family support, the child tax credit, the new in-work payment and the parental tax credit) abates increases to $27,500 on 1 April 2006, and there will be only one rate of abatement of 30c for each dollar of income above the threshold. The rates of family support increase again by $10 for every child on 1 April 2007. The family support rates and threshold will increase by the Consumers Price Index once it reaches 5% since the last change in either rates or threshold.

In-work payment

A new in-work payment is introduced on 1 April 2006. It will be available for sole parents who work 20 hours, and couples who work at least 30 hours per week between them as long as they are not receiving a benefit or student allowance. The rate of the payment is $60 per week for up to three children and $15 per week for the fourth and subsequent children.

Phasing out the child tax credit

When the new in-work payment is introduced, from 1 April 2006, the child tax credit will be phased out. If families qualify for the in-work payment, they will receive this tax credit rather than the child tax credit. Those families that do not qualify for the in-work payment on 1 April 2006 but who still qualify for the child tax credit will continue to receive the child tax credit until such time as they no longer meet the eligibility requirements. The child tax credit will be closed to new applicants after 1 April 2006.

Delivery improvements

The changes include certain improvements to the delivery of family income assistance. The main improvements relate to the transfer of information from the Ministry of Social Development to Inland Revenue, which will facilitate better access to family income assistance by families and help reduce year-end debt. This new transfer of information will allow Inland Revenue to identify people's entitlement more quickly and accurately. Recipients of family income assistance may also now elect to receive payments on a weekly basis, in addition to the option of receiving fortnightly or lump-sum payments.

Background

The specific objectives of the amendments to part KD of the Income Tax Act 2004 are to:

- make work pay for parents who move off a benefit and into work, and
- increase family income to ensure that all families have sufficient income to raise their children and maintain a minimum standard of living.

The package targets low-income and middle-income families with children because they are often little or no better off in work than on a benefit, once work-related costs, benefit abatement rates and tax are taken into account. It aims to remove the cost of raising children as a barrier to entering the workforce and increases the returns for those wanting to work.

The changes to family income assistance are complemented by additional financial support for families through the accommodation supplement and childcare subsidies, the details of which are not covered in this item.

Application dates

The package is to be introduced over three years, with the final increases in family support rates coming into effect on 1 April 2007.

The application dates for the changes to family income assistance are:

From 1 April 2005:

- increase in family support of $25 per week for the first child and $15 per week for each subsequent child.

From 1 April 2006:

- introduction of the in-work payment and phasing out of the child tax credit
- introduction of one abatement threshold for family income assistance (family support, in-work payment, child tax credit and parental tax credit) of $27,500 with an abatement rate of 30c for each dollar of family income assistance
- increase in the family tax credit to ensure those in work are not worse off than on benefit.

From 1 April 2007:

- additional increase in family support of $10 for each child
- indexation of family support begins.

Detailed analysis

Family support

(Sections KD 2(3) and KD 2(6))

Rates and threshold

From 1 April 2005 the maximum rates of family support will increase by $25 a week for the first (or only) eligible child and by $15 a week for all subsequent eligible children. All maximum family support rates will then increase by a further $10 a week from 1 April 2007.

Family support maximum rates (per week)

	Current rates	Rates from 1 April 2005	Rates from 1 April 2007
First or only child aged < 16 yrs	$47	$72	$82
First or only child aged > 16 yrs	$60	$85	$95
Subsequent child aged 0–12 yrs	$32	$47	$57
Subsequent child aged 13–15 yrs	$40	$55	$65
Subsequent child aged 16 + yrs	$60	$75	$85

The threshold at which family income assistance starts to abate will increase to $27,500 from 1 April 2006. Note that family support is the first tax credit to abate, followed by the child tax credit or new in-work payment, and finally the parental tax credit. An amended Schedule 12, which specifies the income bands used for the ongoing calculation of family income assistance, comes into force on 1 April 2006, to reflect the higher abatement threshold

Ring-fencing of family support

(Section KD 2(6) and KD 2(6B))

New rules will come into force on 1 April 2005 to amend the current abatement calculation that ensures family support is not subject to any abatement during the period people are in receipt of an income-tested benefit and their income is below the abatement threshold for family support. The new rules, described as "ring-fencing", exclude from the abatement calculation the period of time that people are in receipt of a benefit if their annualised income (calculated on a month-by-month basis) is less than the abatement threshold (currently $20,356 per year). The annualised income will be based on both employment (including self-employment) and benefit income earned in each month.

The ring-fencing rules are to deal with the following concern. Benefits are paid primarily on the basis of current weekly income to meet living costs. Entitlement to family income assistance, including family support, is based on annual income over the income year. This means that a family with moderate to high income for the first part of an income year may not be entitled to full family support, even though the family spends the latter part of the year on a benefit, with a very low income.

Conversely, a family on a benefit and receiving maximum family support for the first part of the year may have an end-of-year debt for some or all of its family support because of high income earned in the later part of the year.

In-work payment

(Section KD 2(2) and KD 2AAA – definition of "child", "principal caregiver", "employment" and "full-time earner")

A new in-work payment is introduced from 1 April 2006 to replace the child tax credit. Working families can receive the in-work payment as well as other family income assistance such as family support.

The new in-work payment is worth up to $60 a week for families with up to three children. For larger low-income families, an extra $15 a week is paid for each of the fourth and subsequent children.

The in-work payment will be paid to the principal caregiver and it will be available to working parents (including self-employed parents) who do not receive a

benefit and are working for a minimum number of hours a week. Sole parents will need to work at least 20 hours a week and couples at least 30 hours a week between them to qualify for the payment.

Principal caregiver

The definition of "principal caregiver" in section OB 1 means a person who has the primary responsibility for the day-to-day care of the child. The principal caregiver must be over 16 years of age and the child must be maintained as a member of the person's family and be financially dependent on that person. A "child" is defined in section OB 1 of the Income Tax Act 2004 as an unmarried person who is aged 15 years or less, aged 16 or 17 years and not financially independent, or aged 18 and not financially independent and still attending school or a tertiary educational establishment.

It is important to note that the definition of principal caregiver for the purposes of the in-work payment is the same as for family support. In other words, if a parent meets the criteria for principal caregiver with respect to family support he or she will also be considered a principal caregiver for in-work payment. This includes the condition that the parent is responsible for the day-to-day care of the child, even though the care of that child may be assigned to a third party for example, a boarding school).

A child for whom an unsupported child's benefit, an orphan's benefit or a foster care allowance is paid, will be treated as a dependent child for the purposes of the in-work payment. This means that a person receiving such payment for a child is eligible for the in-work payment.

Residence

The residence requirements for the in-work payment remain the same as for other forms of family income assistance. The principal caregiver has to be both resident and present in New Zealand for a 12-month continuous period, and at the time of claiming the tax credit be a tax resident and present in New Zealand. The child has to be both resident and present in New Zealand during the eligible period for which the credit is claimed.

Full-time earner

The principal caregiver, and spouse (if any) must either or both receive income from employment (including self-employment) and must be engaged or normally engaged in that employment as a full-time earner. Income from employment for the purposes of the in-work payment consists of:

- salary or wages and withholding payments (except payments made to non-resident contractors) as defined in OB 1 of the Income Tax Act 2004
- salary or wages or other income paid to a shareholder-employee of a close company that is not subject to PAYE[1], and
- income from any business carried on for profit.

Several types of income included in the definition of "salary or wages" for tax purposes are excluded for the purposes of the in-work payment. They are:

- periodic payments by way of pensions and the like relating to past employment
- payments that are income under section CF 1 of the Income Tax Act 2004 (benefits, pensions, compensation and government grants)
- income-tested benefits
- veterans' pensions
- New Zealand superannuation
- living alone payments
- student allowances, and
- weekly compensation payable under the Injury Prevention, Rehabilitation, and Compensation Act 2001 and its predecessors.

The definition of "employment" for the purposes of the in-work payment also caters for the situations where, in any day, someone works for a number of hours less than the number he or she would normally work in a day, but is paid as if the hours normally worked had been worked. This would cover days on sick and annual leave and statutory holidays. In these cases, the person treated as being paid is employed on those days for the number of hours paid.

The legislation adopts the phrase "would normally be a full-time earner" to describe eligibility for the work test for in-work payment. This is to prevent someone being denied the in-work payment for a week in which his or her hours worked are less than normal hours. For example, if someone normally works 30 hours including overtime but did no overtime in a particular week, the person would be treated as working 30 hours all the same, because these are the hours normally worked.

In-work payment and ACC

People who would have been engaged in paid employment and working the required number of hours but are incapacitated owing to personal injury by accident and are receiving weekly compensation, will be treated as being engaged in paid employment for the purposes of the in-work payment. This will ensure that they continue to receive the in-work payment while in receipt of weekly compensation.

In addition, people or their spouses who have suffered an incapacity owing to personal injury by accident on or after 1 January 2006 and who are receiving earnings-related compensation and would have satisfied the in-work test but for that incapacity, will be treated as being eligible for the in-work payment. This will only apply if they were receiving the child tax credit for an eligible period ending on 31 March 2006. The purpose of

[1] A close company is one that has 25 or fewer shareholders

this provision is to ensure that those parents who were receiving the child tax credit, but who are not working owing to an accident, will have their entitlement to the child tax credit transferred to the in-work payment at the time of its introduction.

Other eligible recipients

Eligibility is extended to recipients of New Zealand superannuation and veteran's pension working the required number of hours, both parents who share custody of a child, and recipients of foster care allowance, orphan's benefit or unsupported child's benefit, provided they work the required number of hours.

People receiving paid parental leave or the parental tax credit may also qualify for the in-work payment under certain circumstances. They must have met the work test before taking leave leading to the birth of a child, and they will receive the in-work payment only for the period for which they are receiving the parental tax credit or paid parental leave. This is up to a maximum of eight weeks for parental tax credit and 13 weeks for paid parental leave as of December 2004, and 14 weeks as of 1 December 2005. During other time off work because of the birth of a child, parents will not qualify for the in-work payment if they are not meeting the work test. Note that they must also meet all the other criteria for the in-work payment, such as the residency and principal caregiver requirements.

Shared custody rules

In relation to the in-work payment, a person will be a principal caregiver if he or she has the exclusive care of the child for periods totalling at least one-third of the year, even if the period of exclusive care does not coincide with the period the person is entitled to the in-work payment. This is to ensure that people who meet the shared care test will be entitled to the in-work payment even though they do not have exclusive care of the child in the period the in-work payment is claimed.

It will be necessary to consider ongoing custody arrangements to determine whether the one-third of the year test has been met for the purposes of the in-work payment. It is not meant to be a week-by-week test. For example, a principal caregiver may have exclusive care of a child for the last six months of the year (in which case the caregiver would meet the shared care rule of having care of the child for one-third of the year) but may only be eligible for the in-work payment in the first half of the year (because the hours test is not met during the second half of the year). Although the two periods do not overlap, the person will still be entitled to the in-work payment for the first half of the year.

The shared care rules also ensure that if the person meets the shared care test based on the current shared care arrangement, but at some time later in the income year the arrangement changes so that the shared care test will not be met, they are treated as being a principal caregiver until that arrangement changes. The legislation does require, however, principal caregivers in shared care arrangements to inform the Commissioner of any changes in the arrangement that will have the effect of their no longer being treated as principal caregivers.

Finally, when both parents are receiving the in-work payment or one parent is receiving the in-work payment and the other parent is receiving the child tax credit, both parents party to the shared care arrangement are entitled to claim the full amount of their respective tax credits. In other words, there is no apportionment of the credit, and each principal caregiver may receive up to the maximum amount. Providing the full entitlement of the in-work payment and child tax credit to parents in shared care situations differs from the current child tax credit and family support rules, where the tax credit is apportioned between the parents based on the proportion of time each parent cares for the child or children.

Phasing out of the child tax credit

(Section KD 2AAAB)

As of 1 April 2006, people will continue to be entitled to receive the child tax credit in respect of dependent children in the following circumstances. They have been eligible for a child tax credit for an eligible period ending on 31 March 2006 and are not eligible for an in-work payment, and continue to be eligible for a child tax credit at all times after 31 March 2006. Once someone loses their eligibility for the child tax credit after 1 April 2006, they will no longer be able to regain it. Eligibility for the child tax credit ceases for reasons such as moving onto a benefit or starting to meet the in-work payment work test.

Family tax credit

(Section KD 3(3), KD 3(5) and KD 5C)

Under the current rates, it is possible for some couples with children to be worse off moving from a benefit into full time work, even after receiving the family tax credit, because of the effects of benefit abatement and taxation. To prevent this occurring, the level of the family tax credit will increase over time.

From 1 April 2006, the family tax credit will increase each year to ensure it does not lose its value over time. This will mean that families do not have a reduction in income when moving off a benefit and into employment of 20 hours a week for sole parents, or 30 hours a week for couples. The legislation does not specify the exact increase in the family tax credit, as it depends upon subsequent increases to benefit levels each year. It is expected that the rate of family tax credit on 1 April 2006 will increase from $15,080 net per year to approximately $17,000 net per year.

Regular adjustment of family income assistance

(Section KD 5C)

A key contributing factor to inadequate family income is the declining real value of family support, which has never been regularly adjusted to compensate for inflation. Although core benefits and most supplementary assistance delivered by the Ministry of Social Development are generally adjusted annually, family support is not. The last increase in family support rates was in 1998.

From 1 April 2007, the rates and thresholds of family support will regularly adjust in line with increases in the Consumers Price Index by Order in Council.

The first increase in family support rates and threshold is when the total percentage increase in the movements in the quarterly "all groups" index number of the Consumers Price Index from that applying on 1 April 2007 is 5% or more. Subsequent increases will occur when the quarterly "all groups" index number of the Consumers Price Index increases by 5% or more from the time of the requirement to make the last adjustment. An Order in Council can be made no later than 1 December in a year and must apply from 1 April the following year. This means that the September quarter index will be used to measure increases in the Consumers Price Index.

The new legislation also provides for the Minister of Revenue, in consultation with the Minister for Social Development and Employment, to review the rates of in-work payment and the parental tax credit every three years. The first review must take place no later than 30 June 2008, and subsequent reviews must occur no later than 30 June in the third year after the preceding review.

The family tax credit will increase on 1 April each year by an amount sufficient to ensure that families with children do not have a reduction in income when moving off a benefit into 30 hours or more of paid work a week. This change occurs from 1 April 2006.

Delivery improvements

(Section 85G of the Tax Administration Act and KD 7 of the Income Tax Act 2004)

The Working for Families package also includes certain improvements to the delivery of family income assistance. One of the main enhancements relates to the transfer of information from the Ministry for Social Development to Inland Revenue which will facilitate better access to family income assistance and help reduce year-end debt.

Currently, a working person who receives family income assistance from Inland Revenue, who then becomes unemployed and starts to receive a benefit, will begin to receive family income assistance from the Ministry of Social Development. The Ministry of Social Development pays family support on Inland Revenue's behalf to people on benefits, except when they earn more than $20,356. It is an individual's responsibility to advise Inland Revenue of a change in circumstances, so that it they can cease paying family support and other family income assistance (such as the in-work payment) unless the person involved chooses to continue with payment from Inland Revenue. If someone delays notifying Inland Revenue, double payments of family support occur and Inland Revenue continues paying other family income assistance. This may eventually be detected by the existing Inland Revenue/Ministry of Social Development information exchange but not before debt arises.

The purpose of the provision is to allow for the cessation of payment of family income (family support, child tax credit, in-work payment, parental tax credit, and family tax credit) by Inland Revenue as quickly as possible, for those clients granted benefits and family support payments by the Ministry of Social Development, in order to avoid creating debt. Inland Revenue will cease payment of family income assistance when it receives notification from the Ministry of Social Development that an individual has been granted a benefit and family support.

Ceasing payment of family income assistance is an "adverse action" in terms of section 103 of the Privacy Act 1993 and, as such, it requires Inland Revenue (as the agency matching the information it receives from the Ministry of Social Development with its records) to give recipients notice of the planned action and allow them five working days to show why it should not be taken. However, delaying the payment cessation process by effectively ten days would defeat the purpose of the information match. Consequently, amendments to Section 3 of the Privacy Act and Section 85 of the Tax Administration Act 1994 were enacted to allow for the information exchange.

The information exchange also allows the Ministry of Social Development to inform Inland Revenue of people who move off a benefit and into paid work. This information is necessary so that Inland Revenue can invite people to apply for assistance once they start work while full family support continues to be paid for up to eight weeks.

Finally, section KD 7 of the Income Tax Act 2004 has been amended to allow the Commissioner to pay family income assistance on a weekly basis. Previously, recipients could elect only between fortnightly or lump-sum payments of assistance. As of 1 April 2005, recipients will have the additional option of weekly payments.

Child support changes

(Section 30 of the Child Support Act 1991)

Changing the rates and thresholds of family support has an impact on the calculation of child support payments for liable parents. The amount of child support to be paid by a liable parent depends on a number of factors, including the liable parent's living allowance, which is deducted from the liable parent's taxable income.

The living allowance for a liable parent with dependent children is calculated on the basis of the gross married rate of invalid's benefit plus family support at the subsequent child rate for up to four dependent children. An increase in the rates of family support would, therefore, increase the living allowance and decrease the amount of child support paid by the liable parent.

To prevent decreases in child support payments arising from increases in family support rates, the Child Support Act has been amended to set the current family support rates ($2,444 per annum for each child) for the 2004/05 income year in the living allowance component of the formula for calculating child support. This measure, which comes into effect on 1 April 2005, removes the explicit link between any future family support increases and the calculation of the liable parent's living allowance.

The current family support rates in the living allowance will increase by the average movement in the Consumers Price Index during the twelve-month period that ends 31 December before the start of the following child support year. This is to ensure that the family support component of the living allowance rises with the cost of living. The indexation will come into force for child support years beginning 1 April 2006.

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.

JURISDICTION OF THE TAXATION REVIEW AUTHORITY

Case:	TRA 020/04
Decision date:	14 May 2004
Act:	Taxation Review Authorities Act 1994
Keywords:	Agreed adjustment, ultra vires, jurisdiction

Summary

The Taxation Review Authority had no jurisdiction to deal with the matters in the application of the taxpayer. The matters could only be dealt with in a Court of general jurisdiction.

Facts

In May 2000 the taxpayer agreed to a proposed adjustment in order to settle his tax disputes with the Commissioner.

The taxpayer later alleged that he had signed the adjustment because he felt oppressed and intimidated by the Commissioner into concluding the agreement. He also alleged more serious allegations of a criminal nature against the Commissioner, all of which were denied.

On 23 November 2001 the Commissioner issued proceedings to enforce the assessment. The taxpayer was no longer entitled to challenge the agreed assessment due to time-bar restrictions.

On 11 June 2002 the Commissioner obtained judgment against the taxpayer in the District Court for $360,909.47.

On 21 November the Commissioner served a bankruptcy notice on the disputant. He did not satisfy the notice and a petition and summons for adjudication were served on him on 5 March 2003. It was set down for hearing on 12 March 2003.

On 10 March 2003 the taxpayer applied to set aside the District Court judgment. The grounds of that application included the allegation that he was coerced into signing the agreed adjustment.

On 12 March 2003 the District Court held that it had no jurisdiction to entertain a challenge to a tax assessment and that it could only be achieved in the Taxation Review Authority ("TRA")

The taxpayer sought declarations in the TRA to the effect of:

- Setting aside the agreed adjustment and that the decision to enter into the adjustment was ultra vires as there is no liability for the tax which was the subject of the agreed adjustment
- That the Commissioner had credited payments to the taxpayer's business rather than the taxpayer personally.

Decision

Authority Willy held that under sections 13 and 13A of the Taxation Review Authorities Act 1994, the TRA had no jurisdiction to deal with the matters in the application and that they could only be dealt with in a court of general jurisdiction. The taxpayer must rely, if he wished to continue his dispute, on the application to set aside the judgment in the District Court. The application for declarations was dismissed.

APPLICATIONS FOR LEAVE TO BRING PROCEEDINGS OUT OF TIME AND SUMMARY JUDGMENT

Case:	GAR Palmer v CIR
Decision date:	1 June 2004
Act:	Goods and Services Tax Act 1985
Keywords:	Leave, out of time, summary judgment application

Summary

After a discussion of the Limitation Act 1950, the District Court declined the plaintiff's applications.

Facts

On 5 February 1996 and 2 January 1998, the CIR issued GST refund cheques to two companies (for $29,013.21 and $59,422.03 respectively). Both companies were associated with Mr Palmer. These cheques were stopped shortly after being issued to allow for further investigation into the companies.

Mr Palmer claimed to have acquired those two cheques by Deeds of Assignment dated 21 February 1996, for the first cheque, and 20 January 1998, for the second.

Mr Palmer argued that the CIR stopped the cheques without lawful cause or reason, and, having acquired the cheques, that he was entitled to summary judgment in the District Court for the full amount of them.

Decision

His Honour Judge Joyce determined that the first hurdle to be overcome in order for the plaintiff to succeed was that of limitations. Mr Palmer had included an "Application for Leave to Bring Proceedings Out of Time" for each of the cheques.

Joyce J noted though, that while Mr Palmer would have it that he acquired not simply the cheques and their worth under the Deeds of Assignment, but also any causes of actions arising from them, on a proper construction the documents simply recorded the purchase of the cheques from their respective owners. In point of fact, section 7C of the Cheques Act 1960 was specifically mentioned in the intitulment of the two Deeds.

That aside, it was common ground that the starting point was to accept that any action was subject to the 6-year limitation period provided for by section 4(1) of the Limitation Act 1950. Mr Palmer accepted that he knew of the stopping of each cheque when it occurred, as did the companies to which they were issued. However, Mr Palmer argued that, for various reasons, he was unable to bring the proceedings at an earlier time.

Mr Palmer claimed that his circumstances amounted to him having been under a "disability", but His Honour noted that "even were they entirely factual, I would be unable to identify [them] as within the scope of a "disability", as that expression is to be understood in terms of s24 of the Limitation Act 1950." "Disability" is defined as relating to infancy or unsoundness of mind.

After canvassing and dismissing several other possible exceptions to section 4(1), Joyce J then turned to consider Mr Palmer's argument that section 45 of the GST Act 1985 extended the period of limitation to eight years in respect of GST payments. This, too, was dismissed.

Having noted that a prior attempt to recover on the same cheques, by companies created at the behest of Mr Palmer, had been struck out in 2001, His Honour briefly considered the merits of the summary judgment application. On this point, he stated:

> "Thus, even had I been taken to the point where it was necessary to address in detail the competing contentions surrounding the supposed merits of claim and defence in respect of the cheques, the high likelihood – if not certainty – would have been that I would have been bound to dismiss the Summary Judgment Application."

It was not necessary to address those contentions, though, as Joyce J held that both of Mr Palmer's claimed causes of actions were barred by section 4(1), and there were no circumstances permitting circumvention of that bar. The plaintiff's summary judgment application and statement of claim were struck out.

AVAILABILITY OF INPUT TAX CREDITS

Case:	Ch'elle Properties (NZ) Ltd v CIR
Decision date:	3 June 2004
Act:	Goods & Services Tax Act 1985, Tax Administration Act 1994
Keywords:	Input/output tax, invoice/payment basis, property transactions, deferrable contracts, credit contracts, contract cancellation, tax avoidance arrangement, tax advantage, objective test

Summary

The taxpayer had claimed GST input tax credits on a total of 117 property transactions. Payment to the vendor was by way of a small deposit with the remainder payable on settlement. The difference in registration types (payment and invoice) between the parties saw the taxpayer claiming an input credit on the entire purchase price whilst the vendor only paid output tax on the deposit paid. The Commissioner considered the arrangement was set up for the tax advantages it could obtain and alleged tax avoidance under section 76 of the GST Act. The Commissioner was also claiming section 25 applied as the original contracts had been cancelled.

Facts

In November 1998 a group of 114 companies ("the A Companies") entered into conditional contracts with W Developments Ltd to purchase 114 lots of land in a subdivision. The A companies were all incorporated by Mr Nigel Ashby ("Mr Ashby") who was the sole director of each company.

Each agreement provided for a purchase price of $70,000, with an initial deposit of $10 on execution and a further subsequent payment of $29,990. The remainder of the purchase price was payable on settlement.

In May 1999, Ch'elle entered into conditional agreements with the A Companies to purchase from each company a section of land in the subdivision for a total price in excess of $80 million.

Ch'elle was registered for GST on an invoice basis, and the A Group of companies on a cash basis. This meant an input tax deduction could be claimed by Ch'elle immediately, but the A Group of companies would not be required to account for GST on each transaction until settlement funds were received.

Prior to these 114 property transactions, Ch'elle had applied for a private binding ruling (PBR) in August 1998 in relation to a property transaction it had entered into that same month, initiated by Mr Ashby who was tax agent for the vendor. An initial deposit of $100 was paid with deferred settlement of the purchase price ($655,000) in 12 years. Ch'elle entered into two similar property transactions in September and November 1998. These initial property transactions were known as "the three North Shore properties".

The PBR issued in June 1999 approved the payment of the GST refund for the August 1998 transaction on the basis it was a credit contract. The input credit was therefore based on the present day value of the property.

In the GST period ended 31 May 1999, Ch'elle claimed input tax credits on the purchase of 13 properties, made up of the three North Shore properties and 10 of the 114 property transactions. The claims were based on the present day value of the properties.

In the GST period ended 31 July 1999, Ch'elle claimed input tax credits on the remaining 104 properties. However, the input credits claimed were based on the future value of the properties, resulting in a claim of nearly $9 million.

The CIR investigated the claims and subsequently issued NOPAs disallowing them. The dispute went to the Adjudication Unit which found for the CIR on the basis the 114 transactions formed part of a tax avoidance arrangement. However, it found the three North Shore Properties did not form part of this arrangement.

On 12 September 2000 all 114 contracts between the A Companies and W Developments Ltd were cancelled for failure to settle. Vendors of two of the three North Shore properties were subsequently placed in liquidation and the properties on-sold to third parties by the liquidators.

High Court decision

The following issues were to be decided by the appeal:

(a) Whether section 76 of the GST Act applied in that the transactions defeated the intent and application of the GST Act, and

(b) Whether section 25 of the GST Act applied upon cancellation of the contracts.

Section 76 – tax avoidance

Ch'elle's primary submission in the appeal was that as the GST Act had been complied with, its intent and application had not been defeated. Hansen J found that the fact the scheme had complied with the specific requirements of the GST Act did not provide an answer to the finding of tax avoidance. Section 76 called for a more broadly based enquiry than that required to establish technical compliance. It required the arrangement to be assessed by reference to the principles underlying the GST Act.

Hansen J rejected Ch'elle's submission that a tax advantage was essential to finding tax avoidance under section 76. He considered that if the CIR was satisfied that an arrangement had been entered into to defeat the intent and application of the GST Act, he was required to treat the arrangement as void. The CIR is then to adjust the tax payable in a manner he thinks appropriate to counteract **any** tax advantage obtained under the arrangement.

Hansen J disagreed with the TRA finding that section 76 required proof of intention. He considered it was directed to the effect or purpose of the arrangement and should not depend on judgements as to what the taxpayer had in mind.

Hansen J agreed with the CIR that the scheme offended the underlying intention of the legislation that an overall balance is to be achieved between outputs and inputs of registered persons and that there should be a reasonable correspondence of time for which inputs and outputs are accounted for. The balance between the outputs and inputs in this case were grossly distorted by the gap of 10 to 20 years. The uncertainty of the underlying contractual arrangement raised further doubt as to whether liability for output tax would ever arise.

Cancellation of credit contracts and Section 25

Hansen J briefly considered the submissions concerning section 25 of the GST Act, despite the finding of tax avoidance rendering these arguments academic.

Ch'elle submitted that the TRA was wrong in finding that the contracts had been fundamentally varied or altered by the cancellation and that the contracts between Ch'elle and the A Companies remained on foot.

Justice Hansen rejected this submission on the basis that it implied that the question of whether a vendor owned or had the right to acquire the land it was selling was irrelevant to the question of supply. He considered in analysing the nature of a supply, careful consideration of the legal arrangements entered into should be made in light of the factual background. Once the contracts were cancelled the basis on which the supply was made was changed.

The three North Shore properties

The TRA did not make any make decision regarding these properties. Further evidence was requested and presented at an additional hearing. By that time the appeal had been filed no decision had been reached on them and counsel considered it was appropriate that the High Court should consider the outstanding issues on these properties.

Hansen J considered however, that it would not be appropriate for these matters to be dealt with by him when the hearing had not been completed by the TRA. He also considered that the TRA should hear further from the parties before deciding these matters.

FRAUDULENT AND WILFULLY MISLEADING

Case:	TRA 037/2000
Decision date:	3 June 2004
Act:	Income Tax Act 1976, Goods & Services Tax Act 1985
Keywords:	Time-bar, statute bar, fraudulent or wilfully misleading

Summary

The Commissioner was successful in obtaining an interim ruling that the Commissioner was entitled to rely on section 25(2) of the Income Tax Act 1976 in reopening the Disputant's 1990 to 1995 income tax years and making the consequential GST amended assessments.

Facts

This is an interim ruling by the Taxation Review Authority ("the Authority") as to whether the Commissioner was entitled to rely on section 25(2) of the Income Tax Act 1976 ("the Act") in making amended assessments against the disputant for the 1990 to 1995 income tax years. The Commissioner had relied on the disputant's returns being fraudulent or wilfully misleading.

Evidence was given for the disputant by the disputant who was a medical practitioner, and his accountant. The disputant had given evidence as to the operation of his medical practice. The accountant gave evidence as to the preparation of the disputant's financial statements and income tax returns.

Evidence for the Commissioner was given by:

– two receptionists who had worked for the disputant

– a medical practitioner who had practised with the disputant from 1988 to 1995

– the disputant's former wife who had assisted the disputant in his medical practice, with his accounts, as well as later working as a nurse in his practice

– a pharmacist at the health and medical centre which he and the disputant co-owned from April 1995 through the use of a company and the disputant's family trust, and

– the department's investigator who had carried out the investigation.

The Authority's decision summarises the evidence given by the various witnesses. Witness credibility was central to this case.

Decision

The Authority, Judge Barber, found in the terms of the evidence he preferred that of the Commissioner. He simply did not believe the evidence of the disputant. He made this finding in terms of his nearly 23 years experience sitting in the District Court and various tribunals in a number of jurisdictions.

The Authority found it settled law that the process of forming an opinion for the purposes of section 25(2) of the Act involves an investigation by someone who may not have the delegated authority to form the final opinion but who can provide the evidential basis to a person who can. The investigator provided the evidence to the Adjudication Unit and a manager of that Unit who held the necessary delegation formed the opinion that the disputant's returns were fraudulent or wilfully misleading as the disputant had suppressed income and had made numerous private expenditure claims as deductions from business income. The Authority considered there was ample evidence for that opinion.

The Authority rejected submissions on behalf of the disputant that the lifting of the statute bar was both inadequate and flawed. The Authority agreed with the disputant that there had to be definite evidence of fraud or wilful misleading and that here, there was. The Authority also found in any case, having heard extensive evidence there was enough evidence to reassess in terms of the Authority's powers to do so.

The Authority held

> "Following a consideration of all the information provided, the appropriate delegate of the [Commissioner] concluded that the disputant suppressed income of at least $200 per week for the 1990 to 1996 income tax years inclusive, and disallowed deductions for the disputant and advised the disputant in detail of each of those. It followed that there was a need for consequential GST adjustments to reflect unpaid GST output tax on the suppressed income and the disallowance of GST input tax on the overclaimed deductions, and full details of these items were supplied.
>
> It seems to me that the delegate formed the necessary opinion that the 1990 to 1995 returns of the disputant were fraudulent and wilfully misleading because the disputant

> had deliberately suppressed income and misclaimed and overclaimed deductions. I am satisfied the necessary opinion was formed prior to the making of the relevant assessments. It is not a requirement of section 25(2), as submitted for the disputant, that the necessary statutory opinion must be formed prior to the issue of a Notice of Proposed Adjustment which is not an assessment nor a notice that the Commissioner intends to adjust a previous assessment. It is merely an outlining of a proposed adjustment to a taxpayer which may or not ultimately be made, depending on the outcome of the Disputes Resolution Process. I am satisfied that the necessary statutorily required opinion was properly formed by the delegate of the [Commissioner] at Adjudication prior to the making of the reassessments."

It follows that the onus falls on the disputant, to the civil standard of the balance of probabilities to show that the Commissioner was wrong in making the amended assessments and by how much the amended assessments were wrong. For income tax the hearing was a hearing de novo and the Authority has the functions and discretions of the Commissioner to redetermine the issue and substitute its opinion for that of the Commissioner, should the facts so require. However, in the case of GST, the Authority is unable to substitute its opinion for that of the Commissioner (refer section 138E(1)(e)(iv) of the Tax Administration Act 1994 and *Auckland Institute of Studies Limited v CIR* (2002) 20 NZTC 17,685 (HC)). This limitation aside, the principles to be applied are the same and the Authority referred to the statement of those principles in the *Auckland Institute of Studies.*

Income suppression

The Authority found that the $200 per week assessed as having been taken on average per week from the business as undisclosed cash is probably rather favourable to the disputant. The Authority was satisfied that the disputant's receipting practices, banking procedures and income tax return preparation process were such that he was able to, and did, suppress income of at least $200 per week on average for the 1990 to 1996 income tax years.

The disputant's income for tax purposes was calculated from bankings to his practice account so that if income was not banked into that account it would not have been returned for income tax (or for GST).

The banking procedure was to total receipts issued since the last banking and banked to that figure. Accordingly, if an amount was not receipted, it was not banked under the disputant's banking procedure. That receipts were not always issued on payment for patient consultations was shown by the receptionists' evidence that receipts were not always issued, by the large amounts of cash which built up in the disputant's drawer and by a comparison of receipts with the GMS schedule. The Authority also accepted that the disputant's own receipting policy was to issue receipts only if the patient requested.

There was also clear evidence from those that worked with the disputant that he regularly took cash.

The Authority was satisfied that large amounts of cash were consistently and regularly taken by the disputant and not put back. In addition, an analysis of the disputant's private cheque books produced at the conclusion of the hearing in April 2002, showed that there was a lack of cash to meet expenses.

Disallowance of expenses

The Commissioner had identified $750,000 of private expenses claimed as business deductions over the 1990 to 1996 income tax years. The disputant had attempted to distance himself from the claiming of these expenses but the Authority was satisfied that he was acutely aware of each item and obsessed with avoiding tax. The Authority found that the disputant was well aware of each item in his financial accounts and returns and that those involved in compiling them were subject to his close and adamant instructions. The Authority then discussed in some detail the items claimed as a deduction by the disputant.

GST

The disputant's GST assessments were consequential adjustments from his income tax adjustments, the under-returning of output tax as a result of the suppressed income and the over-claiming of input tax deductions from the misclaiming of private expenses which were not incurred for the principal purpose of making taxable supplies. The Authority considered the Commissioner properly formed the opinion that the disputant has knowingly and wilfully or fraudulently failed to make a full and true disclosure of all material facts necessary to determine his GST at material times. Accordingly, it was lawful for the Commissioner to appropriately alter the relevant GST assessments at any time even though four years might have expired from the end of any taxable period in respect of which a return was furnished or, as the case may be, an assessment for GST made.

Conclusion

In conclusion the Authority found the opinions formed resulted from the disputant suppressing income of at least $200 per week and claiming numerous private expenses as business deductions. None of this occurred by accident or inadvertently. There was a pattern of annual discrepancies which were great in number and continued over a long period of time. The disputant could not offer any credible explanation regarding any of this.

OPERATIONAL STATEMENT

INCOME TREATMENT OF CERTAIN EXPENDITURES ON CONVERSION OF LAND FROM ONE FARMING OR AGRICULTURAL PURPOSE TO ANOTHER

Introduction

1. This Operational Statement sets out the Commissioner of Inland Revenue's ("Commissioner") practice and provides guidelines as to the income tax treatment of certain expenditures on the conversion of land used for one farming or agricultural purpose to another (hereafter referred to as "agricultural expenditure" or "agricultural expenditures").

Application

2. This Operational Statement sets out the Commissioner's existing position of the application of the law in this area.

Background

3. Inland Revenue has developed guidelines on the correct income tax treatment of certain expenditures incurred in carrying on a farming or agricultural business, particularly in relation to the costs of converting farming properties from one use to another (for example, from sheep farming to dairy farming).

4. This statement has been produced in order to provide greater certainty as to Inland Revenue's practice in relation to the income tax treatment of these expenditures.

5. The practices and guidelines provided in this statement may be applied to a wide variety of expenditures other than those relating to farm use conversions, but they do not cover all situations involving expenditures in carrying on a farming or agricultural business.

Legislation

Income Tax Act 1994

BD 2 ALLOWABLE DEDUCTIONS

BD 2(1) [Definition] An amount is an allowable deduction of a taxpayer

(a) if it is an allowance for depreciation that the taxpayer is entitled to under Part E (Timing of Income and Deductions), or

(b) to the extent that it is an expenditure or loss

(i) incurred by the taxpayer in deriving the taxpayer's gross income, or

(ii) necessarily incurred by the taxpayer in the course of carrying on a business for the purpose of deriving the taxpayer's gross income, or

(iii) allowed as a deduction to the taxpayer under Part C (Income Further Defined), D (Deductions Further Defined), E (Timing of Income and Deductions), F (Apportionment and Recharacterised Transactions), G (Avoidance and Non-Market Transactions), H (Treatment of Net Income of Certain Entities), I (Treatment of Net Losses), L (Credits) or M (Tax Payments).

BD 2(2) [Exclusions] An amount of expenditure or loss is not an allowable deduction of a taxpayer to the extent that it is

(a) of a private or domestic nature, or

(b) incurred in deriving exempt income under Part C (Income Further Defined), D (Deductions Further Defined) or F (Apportionment and Recharacterised Transactions), or

(c) incurred in deriving income from employment, or

(d) incurred in deriving scheduler gross income subject to final withholding, or

(e) of a capital nature, unless allowed as a deduction under Part D (Deductions Further Defined) or E (Timing of Income and Deductions), or

(f) disallowed as a deduction under Part D (Deductions Further Defined), E (Timing of Income and Deductions), F (Apportionment of Recharacterised Transactions), G (Avoidance and Non-Market Transactions), H (Treatment of Net Income of Certain Entities), I (Treatment of Net Losses), L (Credits) or M (Tax Payments).

DO 3 CERTAIN EXPENDITURE ON LAND USED FOR FARMING OR AGRICULTURAL PURPOSES

DO 3 Any taxpayer who in any income year is engaged in any farming or agricultural business on any land in New Zealand shall be allowed a deduction of the amount of any expenditure incurred by the taxpayer in that year, being expenditure that is not deductible otherwise than under this section or under section DO 4, in –

(a) The destruction of weeds or plants detrimental to the land:

(b) The destruction of animal pests detrimental to the land:

(c) The clearing, destruction, and removal of scrub, stumps, and undergrowth:

(d) The repair of flood or erosion damage:

(e) The planting and maintaining of trees for the purpose of preventing or combating erosion:

(f) The planting and maintaining of trees for the purpose of providing shelter:

(g) The construction on the land of fence for agricultural purposes, including the purchase of wire or wire netting for the purpose of making new or existing fences rabbit proof:

DO 4 EXPENDITURE ON LAND IMPROVEMENTS USED FOR FARMING OR AGRICULTURE

DO 4(1) [Land owned by taxpayer] Any taxpayer who carries on any farming or agricultural business on any land owned by that taxpayer in New Zealand shall in any income year other than the income year in which that taxpayer sells or otherwise disposes of that land, be allowed a deduction in respect of any expenditure of any of the kinds specified in Part A of Schedule 7 incurred by the taxpayer or by any other taxpayer in preparing or otherwise developing that land, and being expenditure which is of benefit to the business in that income year.

DO 4(2) [Land not owned by taxpayer] Any taxpayer who carries on any farming or agricultural business on any land in New Zealand which is not owned by that taxpayer shall in any income year other than the income year in which that taxpayer ceases to carry on that farming or agricultural business on that land, be allowed a deduction in respect of any expenditure of any of the kinds specified in Part A of Schedule 7 incurred by that taxpayer in preparing or otherwise developing that land and being expenditure which is of benefit to the business in that income year.

…

SCHEDULE 7

Sections DL 2, DO 4, and DO 5

Expenditure on Land and Aquaculture Improvements

General description of expenditure	Percentage of diminished value of expenditure allowed as a deduction
PART A	
FARMING AND AGRICULTURE	
1. The eradication or extermination of animal or vegetable pests on the land.	5
2. The felling, clearing, destruction, and removal of timber, stumps, scrub, or undergrowth on the land.	5
3. The destruction of weeds or plants detrimental to the land.	5
4. The preparation of the land for farming or agriculture, including cultivation and grassing, but excluding expenditure incurred in respect of any of the items specified in clause 2.	5
5. The draining of swamp or low-lying lands.	5
6. The construction of access roads or tracks to or on the land.	5
7. The construction of dams, stopbanks, irrigation or stream diversion channels, or other improvements for the purpose of conserving or conveying water for use on the land or for preventing or combating soil erosion.	5
8. The construction of earthworks, ponds, settling tanks, or other similar improvements primarily for the purpose of the treatment of waste products in order to prevent or combat pollution of the environment.	5
9. The repair of flood or erosion damage.	5
10. The sinking of bores or wells for the purpose of supplying water for use on the land.	5
11. The construction of aeroplane landing strips to facilitate aerial topdressing of the land.	5
12. The planting of vines or trees on the land other than trees planted primarily and principally for the purposes of timber production.	10
13. The construction on the land of fences, including the purchase of wire or wire-netting for the purpose of making new or existing fences rabbit proof.	10
14. The erection on the land of electric-power lines or telephone lines.	10
15. The construction on the land of feeding platforms, feeding yards, plunge sheep dips, or self-feeding ensilage pits.	10
16. The construction on the land of supporting frames for growing crops.	10
17. The construction on the land of structures for shelter purposes	10

Standard practice

6. When considering the effect of sections BD 2, DO 3 and DO 4 of the Income Tax Act 1994 on expenditure incurred in carrying on a farming or agricultural business, the Commissioner will apply the principles outlined in this statement.

7. The expenditure in a farming or agricultural business can range from normal farming outgoings (for example, rates, fertilising, petrol, feed, water and electricity) through to expenditure incurred as a result of constructing access roads, building dams, sowing land for the first time, and developing and preparing land, which involves activities such as leveling, contouring, grassing, land clearing and cultivation.

Relevant legislation

8. Agricultural expenditure that is revenue in nature is deductible under the normal deductibility provisions (sections BD 2(1)(b)(i) and (ii)). Expenditure of this type will usually be expenditure that is incurred as part of the everyday agricultural business operation. Examples of such agricultural expenditures are feed for stock, water, electricity, maintenance of plant and machinery, fertilising and rates.

9. Expenditure which is capital in nature cannot be deducted under section BD 2(1) because of the general prohibition on capital expenditure set out in section BD 2(2). It may, however, give rise to depreciation deductions.

10. Agricultural expenditure that is capital in nature may be deductible if specified in sections DO 3 or DO 4. Examples of such expenditures are land preparation, development of land, fencing, constructing access roads and removal of timber. Some agricultural expenditures may instead be the subject of depreciation deductions under Part EG, by virtue of section BD 2(1)(a).

11. Where there is an overlap between sections DO 3 and DO 4 in that some expenditures specified by section DO 4 are also specified under section DO 3, taxpayers have the choice of deducting the expenditure pursuant to either provision.

12. Agricultural expenditure that is capital in nature and not deductible under either sections DO 3 or DO 4 will not be deductible unless it qualifies for treatment under the depreciation provisions.

General test: capital v revenue

13. The income tax treatment of the various types of agricultural expenditures is primarily dependent upon whether the agricultural expenditure in question is of a capital or revenue nature.

14. In order to determine the nature of a particular expenditure the following considerations will be taken into account by the Commissioner:

    (a) The character of the advantage sought (whether an enduring benefit is obtained, whether an asset is gained):

    - where no enduring benefit is obtained, no asset is produced or where the product from the expenditure will be consumed over the income year, the expenditure may be of a revenue nature
    - where an enduring benefit does arise or an asset is obtained, the expenditure points to being of a capital nature.

    (b) The manner in which the product of the expenditure is to be used (whether it is to be used in a recurring manner):

    - the expenditure is likely to be revenue where the product from the expenditure is consumed in the business and will require regular outlay to obtain more
    - the expenditure is likely to be capital where the product from the expenditure is used over a number of years and does not reoccur within an income year.

    (c) The means adopted to fund the expenditure (whether the expenditure is funded from fixed or circulating capital, whether payment is periodic, one-off or spread over time):

    - requirement of regular payments over the course of an income year or funding from circulating capital as it is turned over in the course of making a profit will likely point to a revenue nature
    - a one-off payment or payment spread over a number of years funded from the business's fixed capital will likely indicate a capital nature.

    (d) Whether the expenditure is in relation to the profit-yielding structure or the process used to obtain regular returns:

    - the expenditure will likely be of a revenue nature where it is in relation to the agricultural business process to obtain regular returns
    - the expenditure will likely be of a capital nature where it is in relation to the profit-yielding structure of the business.

15. All the considerations will be taken into account and balanced against each other in order to determine whether a particular agricultural expenditure is of a capital or revenue nature.

Applying the tests to expenditure on land conversion

16. The following test may also be used to determine the nature of a particular agricultural expenditure in addition to the capital/revenue considerations set out above:

    (a) Determine the subject matter of the work or the asset in relation to the expenditure in question, and

    (b) Consider the nature and extent of the expenditure (is it substantial or extensive? does the expenditure relate to the improvement of land as the site for carrying on the agricultural business?), and

    (c) Fact and degree (is there a new asset? is there substantial improvement? does the expenditure produce something different, superior or enduring?).

17. Agricultural expenditure will be considered to be of a revenue nature where the subject matter of the work or the asset in question has not had substantial or extensive work done to it and does not result in the subject matter or asset being materially or substantially different. This would include expenditures such as periodic fertilizing, petrol, water, electricity and recurrent grassing.

18. Agricultural expenditure will be considered to be of a capital nature where the subject matter of the work or the asset in question has had substantial or extensive work done to it resulting in the subject matter or asset being materially or substantially different. Such agricultural expenditures would be expenditures such as conversion expenditure (which can include removal of fences and plants, cultivation and grassing in some cases), contouring, leveling and constructing dams.

19. There will be certain types of agricultural expenditures (for example, weeding, pest destruction or minor/part conversion of land) that will be harder to characterize definitively as being either capital or revenue. The character of the expenditure will depend on the facts of the particular case at hand and the overall result of the application of the capital/revenue considerations to it.

20. Where the agricultural expenditure in question is determined to be of a revenue or capital nature, it is of that nature in its entirety.

Discussion

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

The income tax treatment of various agricultural expenditures

(i) Deductibility of agricultural expenditure under the normal deductibility provisions – sections BD 2(1)(b)(i) and (ii)

Sections BD 2(1)(b)(i) and (ii)

22. In calculating income tax liability for any income year, a taxpayer is permitted to subtract from their gross income, any allowable deductions. An allowable deduction is defined in section BD 2 of which the main tests are set out in sections BD 2(1)(b)(i) and (ii) (normal deductibility provisions). A deduction is permitted to the extent that the expenditure or loss is incurred by the taxpayer in deriving gross income or is necessarily incurred in the carrying on of a business to produce gross income. Section BD 2(1)(b)(iii) refers to deductions allowed under separate parts of the legislation, which would include sections DO 3 and DO 4, discussed below.

23. Section BD 2(2) forbids a deduction to the extent that it is of a capital nature (unless it is expressly allowed under Parts D or E). Therefore, when considering whether expenditure is deductible under the normal deductibility provisions the capital/revenue distinction needs first to be considered even though in a number of instances a similar full deduction is available under section DO 3.

24 Outlined below are two approaches, one based on wide general principles and then one using an analogy, itself based on the same principles, relating to expenditure on repairs and maintenance.

Capital/revenue distinction

General introduction (BP Australia)

25. To assist in the determination of the capital/revenue distinction, the courts have laid down a number of tests to be applied to the facts of each case. The leading case is the Privy Council's decision in *BP Australia v F C of T*[1] which held that each case will turn on its own facts, the tests that the courts have laid down assisting to characterize the transaction but no particular one will turn the decision one way or the other. Some may dominate the consideration but all have to be balanced against the others.

[1] [1965] All ER 209

Sun Newspaper Ltd v FCT – Three matters to consider

26. In the case of *Sun Newspapers Ltd and another v Federal Commissioner of Taxation*[2] Dixon J in discussing the capital/revenue distinction states:

> "There are, I think three matters to be considered, (a) the character of the advantage sought, and in this its lasting qualities may play a part, (b) the manner in which it is to be used, relied upon or enjoyed, and in this and under the former head recurrence may play its part, and (c) the means adopted to obtain it; that is, by providing a periodical reward or outlay to cover its use or enjoyment for periods commensurate with the payment or by making a final provision or payment so as to secure future use or enjoyment".

27. As held in *British Insulated and Helsby Cables Ltd v Atherton*[3], if the character of the advantage sought produces an enduring benefit for the business, it will in all probability point to the expenditure being of a capital nature.

28. The second test that Dixon J refers to, ie the manner in which it is to be used, reiterates the premise that the practical and business effects of the expenditure are paramount over any legal rights that might be obtained.

29. The third test, ie the means adopted to obtain it, works on the premise that if the benefit secured is of a revenue nature then there will generally be periodic payments over the period of the benefit. If there is one lump sum payment or payment is for a long period, then the nature of the benefit suggests capital. However, as was pointed out in *BP Australia*, this will not always hold true. Again, the facts of each case must be considered on its own.

30. A further test is whether the expenditure is funded from fixed or circulating capital. Fixed capital relates to fixed assets (for example, plant) which are employed in the business to create the opportunity for making profits or gains. Circulating capital relates to current assets (for example, stock) and is turned over in the course of making a profit and eventually comes back in your trading operations. Expenditure in relation to fixed capital is usually considered to be capital while expenditure on circulating capital is usually revenue.

31. A further consideration put forward in *Sun Newspapers* is the distinction between the business entity or structure or the profit yielding organization as opposed to the process by which it operates to obtain regular returns by means of regular outgoings or outlays. Expenditure incurred on the profit-yielding structure will usually be regarded as being of a capital nature. This principle will particularly apply to expenditure incurred in establishing, replacing, or enlarging the business structure. This can apply to significant restructuring of a farming or agricultural operation.

Adoption of principles in New Zealand

32. The New Zealand courts have followed the principles laid down in *BP Australia* with *Commissioner of Inland Revenue v McKenzies Ltd*[4] being a recent example. The Privy Council has reaffirmed the approach taken in *BP Australia* in *Commissioner of Inland Revenue v Wattie*[5].

Application of capital/revenue tests

33. The following factors will be taken into account when deciding whether expenditure incurred is of a capital or revenue nature:

    (a) The character of the advantage sought (whether an enduring benefit is obtained, whether an asset is gained):
    - where no enduring benefit is obtained, no asset is produced or where the product from the expenditure will be consumed over the income year, the expenditure points to being of a revenue nature
    - where an enduring benefit does arise or an asset is obtained, the expenditure points to being of a capital nature.

    (b) The manner in which the expenditure is to be used (whether it is to be used in a recurring manner):
    - the expenditure is likely to be revenue where the product from the expenditure is consumed in the business and will require regular outlay to obtain more
    - the expenditure is likely to be capital where the product from the expenditure is used over a number of years and does not reoccur within an income year.

    (c) The means adopted to obtain the expenditure (whether the expenditure is funded from fixed or circulating capital, whether payment is periodic, one-off or spread over time):
    - requirement of regular payments over the course of an income year or funding from circulating capital as it is turned over in the course of making a profit will likely point to a revenue nature

[2] [1938] 61 CLR 337
[3] [1926] AC 205, 213 (HL)
[4] [1988] 10 NZTC 5,233
[5] [1998] 18 NZTC 13,991

   – a one-off payment or payment spread over a number of years funded from the business's fixed capital will likely indicate a capital nature.

(d) Whether the expenditure is in relation to the profit-yielding structure or the process to obtain regular returns:

   – the expenditure will likely be of a revenue nature where it is in relation to the agricultural business process to obtain regular returns

   – the expenditure will likely be of a capital nature where it is in relation to the profit-yielding structure of the business.

34. As part of normal farming operations, expenditures incurred such as the purchasing of feed, grassing pastures, buying fertilizer, purchasing stock food and purchasing petrol, will be of a revenue nature and therefore deductible under the normal deductibility provisions.

35. Other expenditures may be incurred in either setting up the business or developing it. Expenditure of this type is in relation to the infrastructure of the business and not to the process of obtaining regular returns. This type of expenditure will be considered to be of a capital nature and not deductible under section BD 2. Examples of these types of expenditures are purchasing of land, building farm structures, acquiring plant and machinery and initial preparation of land for a new activity.

Characterisation of conversion expenditure

36. The types of activities involved in converting a farm to another type of farming operation may be contouring the land, fencing, cultivation and grassing, building of new structures, irrigation schemes and roading. The indicators that point towards this type of agricultural expenditure being of a capital nature are:

(i) The *character of the advantage sought*: Substantial portions of the farming structure will be changed to enable the operation of the new type of farming. The business will be materially different to the previous one and an enduring benefit is obtained.

(ii) The *manner in which it is to be used*: The new structure will form the basis for the new farming operation. The change will presumably last over a number of years and a substantial amount of the expenditure will be one-off and will not reoccur in a periodical manner.

(iii) The *means adopted to obtain it*: Large amounts of expenditure, for example, contouring the land and the building of new structures will most likely be secured by making a one-off payment, most likely from a loan through a bank or finance company. The expenditure will be funded from fixed capital because it produces a business structure from which profits are made.

(iv) *Profit-yielding structure/process*: The expenditure is related to the profit-yielding structure, putting the business in a position to make profits rather than the process to obtain regular returns.

37. Where part of the farmland is developed, the same considerations will apply and it will depend on the facts whether the expenditures are in relation to the profit-yielding structure and are therefore capital, or whether they are related to the process to obtain regular returns.

38. In relation to the question of land preparation expenditure and whether it is of a capital or revenue nature, Lord Johnston in *Vallambrosa Rubber Co Ltd v Farmer (Surveyor of Taxes)*[6], referring to the preparation of land for cultivating rubber trees states:

> "For this purpose land had to be acquired, cleared and drained, roads made, and building erected, before the cultivation began. What was expended for these purposes was I think capital expenditure, and not, in the sense of the Income Tax Act, money laid out and expended for the purposes of the trade".

39. This supports the contention that any development costs, whether incurred when first starting a farm or changing its use, will be of a capital nature and not deductible under the normal deductibility provisions.

40. It is necessary to identify the asset in question (for example, the area of land to be used for the new type of farming) and to use the same tests as previously discussed, to determine the nature of the expenditure. Where the land use is changed materially from its former use, this suggests that the expenditure will be capital. If the change is only required to maintain current or past usage for example, regular fertilizing or grassing, it would tend to suggest revenue.

Repairs and maintenance

Introduction

41. As an alternative approach, the Commissioner has looked at the analogous situation of expenditure on repairs and maintenance (R&M) on assets, as opposed to acquiring a new one.

[6] [1910] SC 519; 5 TC 529

42. The R&M principles have been used by the Commissioner as a guide to the determination of the deductibility of agricultural expenditure because the process of determining whether work carried out on an asset is R&M or not, requires consideration of the capital/revenue distinction and a commonsense approach which looks at the subject on which work is carried out (and then a fact and degree determination of whether the work is substantial). The same is applicable to the determination of agricultural expenditure.

43. A series of relevant principles can be taken from the following cases.

Auckland Trotting Club v CIR

44. *Auckland Trotting Club (Incorporated) v Commissioner of Inland Revenue*[7] held that the first step to determining whether the expenditure in question is deductible R&M is to identify the asset in question. The next step is to determine the nature and extent of the activity.

45. Applying those principles, where the agricultural expenditure is fertilizing for instance, the asset in respect of which the expenditure is incurred is the land. Fertilizing the land is only one minor part of the overall workings of the land. Fertilizing the land does not materially change the land; it is merely replacing the previous fertilizer that was last applied to the land.

45. This is compared to conversion expenditure where although the asset is still the land, the asset is changed in its usage, (for example from sheep farming to dairy farming). If the expenditure is necessary to effect this change in use, it would not constitute revenue expenditure.

Mt Isa Mines v FCT (Improvement on land)

47. In *Mount Isa Mines Limited v F C of T*[8] and *F C of T v Broken Hill Pty Co Ltd*[9] it was held that where the expenditure incurred is in respect of land or the site on which the business is being carried out and is more than minor in nature, the expenditure is of a capital nature.

48. Where the agricultural expenditure is part of the normal farming operations for example, feed, grassing or petrol for farm vehicles, it would not be characterized as being capital in nature as it is not in respect of the farmland on which the farming business is being carried out nor is it more than minor in nature.

49. Expenditures such as contouring, the construction of access roads or conversion of use of the land, on the other hand would be capital in nature as they are for the improvement of the farmland on which the farming business is being carried out and are improvements that have an enduring character, and which require substantial work to be carried out. All parts of those expenditures including incidental grassing and fertilizing (which in other years may be revenue in nature) would be capital in nature.

Poverty Bay Electric v CIR and Auckland Gas (subject matter, nature and extent of work)

50. In the decisions of both *Poverty Bay Electric Power Board v CIR*[10] and *CIR v Auckland Gas Company Limited*[11] it was decided that where the original asset is replaced with another asset that although performing the same function, is newer, substantially superior, performs better, is of a different make-up and requires substantial or extensive work, the expenditure in such a case would be unlikely to be classed as R&M.

51. Expenditures that are incurred for the conversion of farmland from one use to another as well as other agricultural expenditures that are not part of the farm's normal operations (for example, the building of dams or the erecting of power lines), would be non-deductible.

52. The expenditures would result in the land being materially and operationally different after taking into account all the improvements taken together as part of the project. The nature of the work involved with regards to those expenditures would require extensive work. Therefore, expenditure such as conversion of the farmland would be characterized as being capital in nature.

53. The same principle applies whether it is the whole or part of the farmland that is being converted.

Expenditure to be treated as a whole (capital or revenue)

54. The Commissioner has considered whether items in a normal year would be deductible such as grassing costs, should be treated as part of the capital conversion costs.

55. With regards to conversion expenditure, it may be argued that parts of the expenditure qualify as revenue expenditure as they would have been incurred as part of the normal farming operation. Conversion involves grassing, fertilizing, fencing, irrigation and other various activities.

56. As activities such as grassing are usually part of the normal farming operation it may be argued that the grassing expenditure is deductible albeit it was part of the larger conversion activity. Where the conversion expenditure is characterized as capital, the whole of the expenditure is capital and cannot be separated into parts which can be deductible and parts that cannot.

[7] [1968] NZLR 967
[8] 92ATC 4755
[9] (1968) 15 ATD 43
[10] (1999) 19 NATC 15,001
[11] (1999) 19 NZTC 15,011

57. The Court of Appeal in *Poverty Bay* held that:

> "…it is not possible to claim as expenditure on a repair a payment which has not actually been expended for that purpose. There cannot be a dissection of what is spent upon capital work because part of it might otherwise have been laid out on repairs, but was not".

58. The court adopted the reasonings in *Margrett (HM Inspector of Taxes) v Lowestoff Water and Gas Co*[12] and *FC of T v Western Suburb Cinemas Ltd*[13], particularly the words of Kitto J in the latter case:

> "If a total expenditure is of a capital nature, so is every part of it; you cannot take a portion of the work done, such as the erection of a scaffolding and, closing your eyes to the purpose for which it was in fact erected, attribute to the cost of that portion an income nature for no better reason that that the same scaffolding would have been erected in order to serve a purpose which, if it had existed, would have made the total expenditure an income charge".

59. Where a project is held to be capital, it is of that character in total notwithstanding that certain parts of the project might have been undertaken as part of the normal business operations, or might be revenue if repeated in the future.

60. In *Auckland Trotting*, Richmond J stated that no part of the money spent on constructing the new trotting track was, in fact, spent on repairs and it was not possible to treat part of it as notionally spent on repairs when that is not what happened. In the case of conversion expenditure, it is not possible to treat part of the expenditure as notionally spent as revenue expenditure when that is not what happens.

Summary of R&M rules

61. The factors to take into account when determining whether an expenditure is R&M (hence revenue) can be summarized as follows:

    (i) Determine the subject matter of the work or the asset alleged to have been repaired

    (ii) Consider the nature and extent of the work (Is it substantial? Is it extensive? Does it relate to the improvement of land as the site for carrying on business?)

    (iii) It is a question of fact and degree (Is there a new asset? Is there substantial improvement? Is it different, superior or enduring?).

62. Agricultural expenditure that is part of the normal farming operations such as periodic fertilizing, feed for stock, grassing and petrol would generally be classed as revenue expenditure as they do not require extensive or substantial work and do not result in the land being materially or substantially different, unless they are part of a larger capital project.

[12] (1935 19 tc 481 AT PP 488-489

[13] (1952) 86 CLR 102 at pp 107-109

63. Agricultural expenditures such as conversion expenditure, sowing land for the first time, contouring, leveling or the construction of access roads would not be deductible under the normal deductibility provisions as they generally require substantial work and result in the land being substantially improved, materially different and arguably operationally superior. Moreover, improvement of the land as the site for carrying on of the farming business is classed as capital.

64. Certain agricultural expenditures are harder to class definitively as being either capital or revenue. Such expenditures could be weeding, pest destruction or minor/part conversion of land. The result will depend on the facts of the particular case at hand. Generally however, where there is part conversion of farmland, the expenditure would constitute capital expenditure given the nature and extent of the work required in such an undertaking.

(ii) Deductibility of agricultural expenditure under section DO3

65. Even if it is determined that the expenditure is of a capital nature and not deductible under the normal deductibility provision, it may nevertheless be deductible under sections DO 3 or DO 4.

Section DO 3

66. Section DO 3 permits a full deduction in relation to certain expenditures on land that is used for farming or agricultural business purposes. The expenditures that are deductible under section DO 3 would otherwise not be deductible were it not for it or section DO 4. In each case the expenditure must be incurred in carrying on a farming or agricultural business, however.

Types of agricultural expenditure deductible under section DO 3

67. Section DO 3 specifies the types of agricultural expenditure which are to be fully deductible to a person carrying on a farming or agricultural business. The specified expenditures are:

    - The destruction of weeds or plants detrimental to the land.
    - The destruction of animal pests detrimental to the land.
    - The clearing, destruction, and removal of scrub, stumps, and undergrowth.
    - The repair of flood or erosion damage.
    - The planting and maintaining of trees for the purpose of preventing or combating erosion.
    - The planting and maintaining of trees for the purpose of providing shelter.

- The construction on the land of fences for agricultural purposes, including the purchase of wire or wire-netting for the purpose of making new or existing fences rabbit-proof.

68. In the conversion of farmland context, the removal of weed, scrub and stumps and the construction of fences would be expenditures that are fully deductible under section DO 3. However, other similar costs (for example, the removal of existing fences) are not covered and must be considered under section DO 4.

69. It should be noted that where expenditure incurred in the planting of trees is not deductible under section DO 3 (by reason of not being for the purpose of providing shelter or combating erosion), it may nevertheless be deductible pursuant to section DO 7 subject to certain conditions.

(iii) Deductibility of agricultural expenditure under section DO 4

Section DO 4

70. Section DO 4 provides for the treatment of expenditure incurred by taxpayers on improvements made to land that is used for the benefit of their farming or agricultural businesses. The criteria apply whether the taxpayer owns the land (section DO 4(1)) or leases the land (section DO 4(2)). It permits a deduction for the types of expenditure specified in Part A of Schedule 7 that have been incurred in "preparing or developing" the land.

71. Unlike section DO 3, which permits a full deduction, section DO 4 provides for an amortisation-like deduction by allowing a certain percentage of diminished value of expenditure in each year.

Types of agricultural expenditures deductible under section DO 4

72. The types of expenditure on land improvements used for agricultural purposes that are permitted the amortisation-like deduction are specified in Part A of Schedule 7. An example is the preparation of the land for farming or agriculture including cultivating and grassing and the draining of swamp or low-lying lands. Hence such expenditure, even if treated as capital, remains deductible under section DO 4.

73. Expenses in relation to the improvement of land used for farming or agricultural purposes that are capital in nature are permitted an amortisation-like deduction if they are specified in Part A of Schedule 7.

The relationship between sections DO 3 and DO 4

Introduction

74. A comparison of the types of expenditures that are specified by sections DO 3 and DO 4 reveal that there are overlaps in that a number of the expenditures specified by section DO 4 are also specified in section DO 3. Examples of the overlap are the repair of flood or erosion damage and the destruction of animal pests detrimental to the land. The Commissioner has considered the issue of which provision takes priority where there is an overlap.

Purposes of sections DO 3 and DO 4

75. The common theme arising out of both the provisions' purposes is to permit certain agricultural expenditures that are capital in nature to be deductible where they otherwise would not be under the normal deductibility provisions.

76. Section DO 3 permits a full deduction for certain agricultural expenditures whereas section DO 4 provides an amortisation-like deduction for agricultural expenditures that are in relation to land development and preparation.

Difference in wording of provisions

77. Section DO 4 applies to preparation or developmental expenditure. It does not specifically exclude agricultural expenditures from being deductible under section DO 3. Section DO 3 provides for a specified expenditure to be deductible that "is not deductible otherwise than under this section or under section DO 4". On the wordings of the provision, it can be said that some overlap was contemplated and that where there is an overlap, it allows the taxpayer to make a choice as to which provision to apply to deduct the expenditure in question.

Conclusion

78. Where there is an overlap, taxpayers have the choice of deducting the particular agricultural expenditure either under section DO 3 or DO 4.

"Preparing or otherwise developing land"

79. That term is broad and may encompass many facets. The Concise Oxford Dictionary (10th edition)[14] defines "prepare" as "make ready for use or consideration".[15]

80. The term "develop" is defined as "grow or cause to grow and become larger or more advanced; convert (land) to a new purpose".[16]

[14] Concise Oxford Dictionary (Tenth edition, revised) (Oxford university Press; 2001, New York)
[15] Ibid
[16] Ibid

81. Using the definitions, the term "preparing or otherwise developing land" means getting the land ready to be able to farm it including changing the land from one state to a new and improved state (for example, conversion of land from sheep to dairy farming). The amount of preparation versus development will vary from case to case.

82. In the case of virgin land, not previously used for farming, substantial preparation would be required before it could be farmed. Some development would also be required, for example construction of buildings. In the case of converting an existing farm from one use to another (for example, sheep to dairy farming), the amount of development would most likely be greater than actual preparation.

83. In reality, the two terms are used interchangeably and the income tax treatment of the expenses incurred in either undertaking land preparation or land development is the same.

Income tax treatment of "preparing and otherwise developing land"

Normal deductibility provisions

84. Expenditure incurred in preparing and otherwise developing land from one use to another is of a capital nature and not deductible under the normal deductibility provisions.

85. This holds true notwithstanding that some of the expenditure incurred is in relation to items that in the normal course of business operations, would be considered to be revenue and therefore deductible. Once the nature of the project is classified as capital, all the expenditure within are considered to be capital.

Sections DO 3 and DO 4

86. Although expenditure incurred in preparing and otherwise developing land is capital in nature, the expenditure may still be deductible under sections DO 3 or DO 4.

87. Section DO 4 allows a deduction with regards to the types of expenditures specified in Part A of Schedule 7 that were incurred by the taxpayer in preparing or otherwise developing land. Clause 4 of the schedule specifically allows a deduction for "the preparation of the land for farming or agriculture, including cultivation and grassing, but excluding expenditure incurred in respect of any of the items specified in clause 2". Clause 2 refers to the felling, clearing, destruction and removal of timber, stumps, scrub or undergrowth on the land.

88. If as part of preparing the land the taxpayer incurs expenditure in relation to the removal of timber, for instance, then the deduction under section DO 4 in relation to the removal will be pursuant to clause 2 of the schedule and not clause 4.

89. A number of other items are specified in the schedule and depending on the facts of each case, some or all of the expenditure incurred may be deductible under section DO 4. If construction of fences is involved in preparing and otherwise developing of land the deduction for the fence construction under section DO 4 will be made pursuant to clause 13 of Schedule 7.

90. Items of expenditure incurred in preparing and otherwise developing land for agricultural purposes may be fully deductible under section DO 3. The range of items included in section DO 3 is not as comprehensive as those specified in Schedule 7 and some items are deductible under both sections DO 3 and DO 4.

91. Taxpayers have the choice of deducting the particular agricultural expenditure under either sections DO 3 or DO 4 where there is an overlap

Miscellaneous

92. Farmers who are in the business of forestry should not look to sections DO 3 or DO 4. Instead, section DL 2 or the general deductibility provision of BD 2 should be considered for the deduction of forestry expenditure.

93. Sometimes taxpayers incur agricultural expenditure on farmland that they own but let to farmers that carry on a farming or agricultural business on the land. The owners of the land may be allowed deductions in respect of expenditure specified in sections DO 3 or DZ 3 by virtue of section DO 6 provided that the deductions would have been allowed to the owners had they personally carried on a farming or agricultural business on the land during the term of the lease. The types of deductions permitted do not extend to those allowed under section DO 4.

Case examples

Example 1

Scenario

Joe Smith is a sheep farmer in North Canterbury. The time has come for Joe to resow and refertilize his paddocks, activities that he undertakes regularly. Joe uses the same type of grass seed and fertilizer every time.

Tax consequence

Inland Revenue considers the expenditure (sowing and fertilizing) to be revenue as they are incurred regularly as part of the farm's normal operations and hence fully deductible.

Example 2

Scenario

Blossom Kahu is a sheep farmer in Hawke's Bay. She normally undertakes regular resowing and refertilizing but due to drought conditions in recent times she has not been able to afford regular application of fertilizer or resowing of grass. As a result, the farm has deteriorated and production has gone down.

Blossom comes into significant money after her aunt Myrtle left her $500,000. As a result, she is now able to afford the fertilizer application and resowing that she had let slip in the previous years. Fertilizer application increases ten-fold to bring the farm back to its normal productivity level. Contractors are also brought in to plough and sow new grass.

Blossom also decides that given droughts appear to have become more frequent over recent times she will need to install some sort of irrigation. She installs a new system which provides irrigation to one-third of the property so is able to maintain a viable economic unit and production.

As a result of the significant fertilizing and grassing, the farm's production has increased.

Tax consequences

Inland Revenue considers the fertilizing and grassing expenditures to be revenue as, although of a significant level, they are incurred to bring the farm back to its normal former productivity state. The expenditure is also incurred as part of the farm's normal operation albeit deferred. Hence the fertilizing and grassing expenditure are fully deductible under the normal deductibility provisions.

Expenditure on irrigation would be considered to be capital as it is not a recurring expense and brings into existence an enduring asset (irrigation unit). It is not deductible under the normal deductibility provisions. However, it is deductible under section DO 4.

Example 3

Scenario

Jane, a farmer owns 300 hectares of land, which she uses for sheep farming. Due to better financial prospects from dairying, Jane has recently decided to convert 150 hectares of her land to dairy farming.

To do so will require removal of the existing fence on the 150 hectares and the erection of suitable fencing for dairy farming (to allow irrigation systems), demolition of old buildings (necessary for running the dairy cattle on), building a cowshed, border dyking, contouring, grassing and fertilizing.

At the same time, Jane has decided to regrass the remaining 150 hectares of sheep farm as the regular grassing activity is due.

Tax consequences

Inland Revenue considers the two activities to be distinct and separate from each other. Inland Revenue considers the whole of the expenditure associated with the 150 hectares (being a separate identifiable asset) to be capital as a new enduring asset has been created as a result of the expenditure, in effect a new business structure. Although the expenditure is not deductible under the normal deductibility provision, the majority of it is deductible under section DO 3 and/or DO 4.

Therefore the fencing would be fully deductible under section DO 3; the border dyking, contouring, grassing (for the 150 hectares) and fertilizing would be deductible in the amortisation-like manner pursuant to section DO 4; and the cowshed not deductible under either provision, but depreciable. There is no deduction allowed either for a loss incurred on the demolition of the old buildings or for the expenses involved in the demolition.

Inland Revenue considers the grassing expenditure on the 150 hectares of sheep farm to be revenue as it is an expenditure that is incurred regularly as part of the farm's normal operations and hence fully deductible.

Example 4

Scenario

Jake, a sheep farmer, decides to change his farming operations to dairy farming. To do so will require substantial and extensive development such as building a cowshed, border dyking, contouring, erecting suitable fences, clearing timber, regrassing, irrigation and fertilizing.

Tax consequence

Inland Revenue considers the whole of the expenditure to be capital and not deductible under section BD 2(1)(b)(ii). The expenditure resulted in major work undertaken to materially and substantially change the existing farm (ie from sheep to dairy) and brought into existence a

different enduring asset (ie the farm asset). Although the expenditure is not deductible under the normal deductibility provision, it is deductible under section DO 3 and/or DO 4.

Therefore, the fencing would be fully deductible under section DO 3; the border dyking, grassing, fertilizing, contouring, irrigation and timber clearing would be deducted in an amortisation-like manner under section DO 4; and the cow heds not deductible under either provisions, but depreciable.

Example 5

Scenario

The Merino Trust is in the business of renting land and buildings. The trust leases one of its farm properties to a farming partnership, made up of Jack and Jill. The partnership uses the land for dairy farming. The T rust incurs developmental expenditure for the land in getting it ready so that it can be leased out as a dairy farm.

Tax consequence

Inland Revenue considers that the Merino Trust is not able to claim a deduction under section DO 4 for the developmental expenditure, given that it does not carry on a farming or agricultural business even though it does own the land. The farming partnership in the scenario would not be able to claim a deduction for the developmental expenditure either, as although it carries on a farming business it did not incur the expenditure for the benefit of its dairy farming business. Therefore, in this scenario, neither the Merino Trust nor the farming partnership would be able to claim the depreciation-like deduction for the developmental expenditure incurred. However, the lessor may be able to qualify for a deduction of the expenditures covered in section DO 3 by virtue of section DO 6 provided that the deductions would have been allowed had the lessor personally carried on a farming business on the land during the term of the lease.

This Operational Statement was signed by me on 5 July 2004.

Graham Tubb
National Manager (Acting)
Technical Standards

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.

DO THE STATUTORY TIME-BAR PROVISIONS APPLY TO SHORTFALL PENALTIES?

We have been asked to consider whether the statute bar provisions apply to shortfall penalties.

Introduction

Section 113 of the Tax Administration Act 1994 ("TAA"), gives the Commissioner authority to make any alterations to an assessment or determination in order to ensure the correctness of that assessment or determination, notwithstanding that the tax already assessed may have been paid. The Commissioner's power to amend assessments for income tax (section 108) and GST (section 108A) is subject to a four-year time limit. Under the statute bar provisions, when an income tax or GST return is furnished and an assessment has been made based on the return that has been furnished, the Commissioner is then barred from amending that assessment so as to increase the tax after the expiration of four years from the end of the income year in which the return is provided in the case of income tax or from the end of the return period in respect of which the return was provided or assessment made for GST.

The issue of whether the statute bar provisions apply to shortfall penalties arises when an assessment of a shortfall penalty is made under section 94A. Under section 94A a shortfall penalty is to be assessed "in the same way" as the tax to which it relates. The issue is whether section 94A means that if the time-bar provisions apply to a particular tax type then the time-bar provisions also apply to any shortfall penalty imposed on that tax.

When the substantive tax has not been assessed by statute bar

It is worth recalling that it will only be possible to impose a shortfall penalty where there is a "tax shortfall". A "tax shortfall" is the difference between the "taxpayer's tax position" and the "correct tax position" for the return period. The "taxpayer's tax position" is most commonly going to be what has been returned by a taxpayer in their tax return. The "correct tax position" is defined in the TAA as meaning the "correct tax position established under one or more tax laws." Where the operation of section 108 prohibits an increase in the assessment of tax after the statute bar date, and in conjunction with section 109 (which provides that the particulars of an assessment are correct in all respects, except on objection or challenge), then the "correct tax position" will not be greater than the "taxpayer's tax position" and there will be no "tax shortfall". Therefore, where there is a substantive tax position that the Commissioner considers wrong, but that position cannot be amended due to the statute bar, it is that position that is deemed correct by section 109, so there will be no "tax shortfall" and no ability to impose a shortfall penalty after the statute bar date.

It might be thought, in response to this section 109 argument, that section 94A(3) is relevant. Section 94A(3) of the TAA provides that the Commissioner may assess a shortfall penalty before or after unpaid tax has been assessed, or has become assessable or payable, or has been paid. This provides that a shortfall penalty can apply to a matter that has not yet been assessed. However, the provision appears to apply to shortfalls that are yet to be assessed, but that could be assessed, rather than "shortfalls" than cannot be assessed due to a statute bar of the substantive tax. Section 94A(3) was enacted to allow the Commissioner to proceed with a shortfall penalty proposal, without having to wait for the substantive matter to be finally resolved. None of this, however, relates directly to the situation where the substantive tax is statute barred. In such a case, as discussed above, the Commissioner will not be able to establish a "tax shortfall", based on that definition and its interaction with section 109.

When the substantive tax has been assessed by statute bar

If, however, the substantive tax has been assessed prior to the statute bar, the question is whether a shortfall penalty can be imposed beyond the statute bar of that underlying substantive tax. An analysis of the statute bar provisions, section 94A and the surrounding provisions, shows that:

- When reading the statute bar provision on its own, where an income tax or GST return has been furnished and an assessment made based on **that** return, the Commissioner is barred from amending **that** assessment after the expiration of four years. The specific references to income tax and GST and the bar on amending those assessments suggest that the provisions were intended to apply specifically to income tax and GST assessments only.

- This view is also supported by the wording of section 94A(2), which states that the shortfall penalty is to be assessed separately from the tax itself. Therefore, where an income tax or GST assessment has been made the Commissioner is barred from amending that assessment (income tax or GST) and not from amending the shortfall penalty assessment.
- Further, under the statute bar provisions the Commissioner is only prevented from amending an "assessment". By virtue of the definition of an "assessment" in section 3(1), an "assessment" has to be an assessment of "tax". The definition of "tax" does not include a "civil penalty". The definition of a "civil penalty" includes a "shortfall penalty". Therefore, as the statute bar provisions only apply to assessments of "tax" they do not apply to assessments of shortfall penalties. That is, such an assessment is not an assessment of "tax".
- The statutory context of the other (non-income tax and GST) assessment provisions of the TAA (sections 93–104) is also relevant. In particular, for all the other types of tax that are assessed under these provisions of the TAA, there is a provision in the Income Tax Act ("ITA") which deems the particular tax to be treated as income tax for the purposes of the ITA and the TAA (with minor exceptions). There is, however, no such provision in either the ITA or TAA deeming shortfall penalties to be income tax. Indeed, the definition of "tax" in section 3(1) of the TAA specifically excludes a "civil penalty", and a "civil penalty" is defined to include a shortfall penalty. Therefore, it appears that Parliament has made sure the provisions of the TAA (including section 108) apply to different taxes by inserting deeming provisions into the particular regimes of the ITA. The absence of such an explicit deeming for shortfall penalties, and indeed the contra-indication, suggests that provisions relating to "income tax" (including section 108) were not to apply to a shortfall penalty.

Conclusion

For the reasons stated above, it is considered that sections 108 and 108A do not apply to assessments of shortfall penalties. Section 94A does not import the statute bar provisions (section 108 and section 108A) into the assessment of shortfall penalties. The Commissioner is not time-barred from issuing an assessment for a shortfall penalty or from amending assessments of shortfall penalties, as long as there is a "tax shortfall" by the statute bar date.

GST GROUP REGISTRATION OF TRUSTS

Introduction

1. The purpose of this item is to provide an overview of the rules that relate to the GST group registration of trusts.

Legislation

2. Section 55 of the Goods and Services Tax Act 1985 (GST Act) provides for the group registration of registered persons. In grouping, a registered member of a group of entities is nominated to be its representative member. This member will pay GST on behalf of the entire group. In effect, the entire group is treated as one entity. Section 55(1) allows the grouping of two or more companies, which are each registered for GST, and satisfy the requirements of section IG 1 of the Income Tax Act 1994.
3. Section 55(8) of the GST Act provides the rules for determining the group registration of two or more registered persons, which are not each companies. The entities can be natural persons, bodies corporate, or trusts, among other things.
4. Subsection (8) refers to the phrase "not each being companies", which means that not all (or indeed any) members of the group need be companies. For example, a trust and a company can be registered as a group of persons. This subsection applies to groups without companies, and also applies to groups that include one or more companies as well as other entities.
5. "Control" is a necessary element in deciding whether a group exists. One of the following conditions must be met:
    - One of them controls each of the others
    - One person controls all of them, or
    - Two or more persons carrying on a taxable activity in partnership control all of them.

Practice

How has "control" been interpreted by the courts?

6. The principal issue is how widely the term should be interpreted. In particular, does it mean legally enforceable, formal control, or can it include some type of de facto control?
7. *Case K54* (1988) 10 NZTC 444 involved three cases stated to the Taxation Review Authority. Each case involved an entity applying for group registration

under section 55(8) of the GST Act. The issue was whether the Commissioner had correctly exercised his discretion in declining the taxpayers' application for group registration for GST purposes.

8. *Case K54* discussed the meaning of "control" in the context of section 55(8). As Bathgate DJ explained at page 453: "I conclude that 'control' or 'controls' in the context of sec 55 means discernible, legal control".

9. His Honour rejected de facto control because there is no yardstick to determine what is or is not control. For example, de facto control includes assuming control of an entity by reason of age, family ties, family seniority, or business acumen. His Honour, at page 452, added that Parliament's intention was that control, in terms of section 55, should mean "discernible and effective legal control". This description of "control" is more certain than de facto control. Accordingly, "control" is taken to refer to an identifiable legal power vested in a particular person or persons external to the entity, eg the power to vote in respect of company shares. As His Honour suggests, de facto control in the context of group registration is too wide. Parliament could not have contemplated such a wide interpretation. There would be nothing to indicate when that sort of control "stops or starts".

10. In *Case L42* (1989) 11 NZTC 1,261, a partnership applied for group registration under section 55(8) of the GST Act. The Commissioner declined the application. Bathgate DJ affirmed *Case K54* at page 1,262, "namely that there must be discernible legal control". The Taxation Review Authority held for the Commissioner.

11. Therefore, "control" is of the same character applied to companies before they obtain group registration, ie based on holding a majority of the shareholder decision-making rights under the Income Tax Act 1994. In general, legal powers will be reviewed against normal commercial (including accounting) practices.

When does a person have "discernible legal control" of a trust?

12. Generally, a trust is an equitable obligation, which comprises four elements: a trustee, trust property, a beneficiary, and an obligation to deal with the trust property. Trusts can be classified into express trusts or those arising by operation of law.

General rule

13. A trust is unlike a company, as it does not have the equivalent of shareholders. The beneficiaries, subject to the terms of any deed constituting the trust, do not have the power to direct the trustees. The deed permits the trustees to exercise control of the trust assets via unanimous or majority voting. Trustees act under certain fiduciary obligations on behalf of the beneficiaries, and not in their own personal capacity. Each trust is different. Accordingly, the standard position is that no person controls the trustees, and a trust cannot be part of a GST group simply by virtue of it being under the trusteeship of the same person as another member of the group.

14. There are statutory provisions that provide a mechanism for managing trusts, but these do not usually vest control in another person or trustee.

When does a trustee have "discernible legal control" of another person?

(a) Company

15. The trustees have "discernible legal control" when the trust holds more than 50% of the voting power in respect of shareholder decision-making rights. This assumes that the trustees have the power to hold shares and vote at company meetings, in terms of the relevant trust deed.

(b) Partnerships

16. The terms of the agreement will indicate the degree of "discernible legal control" a trustee has in the partnership. Again, this will be generally be dictated by the level of voting power.

(c) Trusts

17. In certain circumstances, a trustee is able to group with another trust under section 55(8). This includes situations involving trustees of subtrusts. Just as the trustee of the principal trust will have control of the trust because of the terms of the deed, where this power in respect of the subtrust is vested in the trustees of the principal trust then it may be considered to control the trustees of the subtrust. However, careful analysis of the terms of the relevant deed will normally be required before Inland Revenue will accept this.

Examples

A person controlling a trust

18. Jim, Reginald, and Isa own 80% of the shares in Balloons Limited. In the deed forming the Azic Family Trust, they have been appointed as the trustees. Both Balloons Limited and the Azic Family Trust carry on taxable activities. The trust deed has given the trustees a wide discretion to exercise their powers. All the trustees have met to discuss the possibility of grouping with Balloons Limited, and unanimously agreed that it is in the interests of the trust to group. The trust deed provides the trustees with "discernible legal control" of the trust, and the same individuals control Balloons Limited.

19. Despite this, in one case the three trustees act on their own behalf as members of Balloons Limited,

and in the other they act in the capacity of trustees of the Azic Family Trust, and could be removed. Inland Revenue does not consider that the same persons control both entities. The trustees may not group the Azic Family Trust with Balloons Limited for the purposes of section 55(8).

A trust controlling a person

20. Rupert is the sole trustee of the Knight Farming Trust. The Knight Farming Trust owns 60% of the shares in Eco-Building Limited. The trust instrument states that Rupert, as trustee, has the legal authority to deal with the trust property for the financial benefit of the beneficiaries. As the sole trustee of Knight Farming Trust, Rupert has "discernible legal control" of Eco-Building because of the trust's 60% share in that company. The Knight Farming Trust may be grouped with Eco-Building Limited.

A trust controlling a trust

21. Healthy Living Limited manufactures organic products. The company decides to create a trading trust called Healthy Living Trading Trust. Healthy Living Limited is appointed as the trustee. The beneficiaries are the owners of the company. Healthy Living Limited acting as trustee decides to create a subtrust called Organo Trust under a power contained in the deed. The instrument settling the Healthy Living Trading Trust provides the trustee with the power to deal with Organo Trust for the financial betterment of the beneficiaries within the general purposes of the Healthy Living Trading Trust, including the power to appoint and remove trustees of the Organo Trust.

22. As the trustee of Healthy Living Trading Trust, Healthy Living Limited has "discernible legal control" of Organo Trust because it is the trustee of both trusts, which are linked together beneficially in the principal deed and can control the subtrust for the benefit of the first trust. Therefore, both trusts may group for GST purposes.

23. This reasoning will also apply where two or more independent trusts are governed by the same or similar trustees.

Note

24. If you would like to apply for group registration, you can get a *Goods and Services Tax Application for Group Registration (GST 4)* form from Inland Revenue's website **www.ird.govt.nz** or order a copy from their automated telephone service INFOexpress on 0800 257 773 (quote 654, not 65T4).

REWRITE ADVISORY PANEL

STATEMENT SETTING OUT THE PROCESS FOR RESOLVING POTENTIAL UNINTENDED CHANGES IN THE INCOME TAX ACT 2004

PANEL STATEMENT – RAP 001

Process for resolving potential unintended legislative changes in the Income Tax Act 2004

Introduction

1. The Rewrite Advisory Panel (the Panel) is an independent committee formed to advise on the rewrite of the Income Tax Act 1994 (ITA 1994). In 2004 the Panel was invited to take on the role of considering whether any unintended legislative changes arise under the Income Tax Act 2004 (ITA 2004) as a consequence of the rewrite process.

2. The Panel will consider all issues submitted, and make recommendations to Government as to how any unintended changes should be dealt with.

3. This Panel Statement sets out the process for taxpayers and agents to refer potential unintended legislative changes in the ITA 2004 to the Panel, and how the Panel will deal with those issues.

Background

4. The ITA 2004 is the third stage of a programme to progressively rewrite New Zealand's income tax legislation. The objective of the rewrite programme is to make the legislation clear, plainly expressed and easy to understand. This will assist with understanding tax rights and obligations.

5. The first stage of the rewrite programme reordered and renumbered the Income Tax Act 1976 and set out the core provisions in Part B of the ITA 1994 with an alphanumeric numbering system.

6. In 1996 the second stage rewrote the core provisions and changed the structure of the Act so that it operated on a gross basis for the determination of income and deductions.

7. The third stage rewrites Parts C to E and Y into plain language and restructures those Parts to provide a link back to the rewritten core provisions (in Parts A and B). Individual provisions are organised into a more logical scheme.

8. The intention of the drafting of the ITA 2004 was to ensure no change to the pre-existing law was made, except in respect of a limited number of intended policy changes.

9. When reporting back the ITA 2004, the Finance and Expenditure Committee (FEC) noted that unintended changes in the law may arise from the difference in language between the old and new Acts, notwithstanding the best efforts of the drafters to avoid this.

10. The FEC proposed the appointment of an independent committee to review submissions regarding any differences between the two Acts and to recommend appropriate action. The Rewrite Advisory Panel has been invited to take on this role.

11. A formal process was called for to identify such issues and refer them to the Government for consideration.

12. Upon identification of an unintended legislative change, the Government will decide whether to:
    - enact an amendment to reinstate or modify the meaning of the pre-existing law, or
    - permit the unintended change to be retained in the legislation.

13. The Government will also decide whether the issue merits wider consultation under the generic tax policy process, eg whether a Government Discussion Document is warranted.

14. The Rewrite Advisory Panel is chaired by the Rt Hon Sir Ivor Richardson and includes representatives from the Institute of Chartered Accountants of New Zealand (ICANZ), the New Zealand Law Society (NZLS), Treasury and Inland Revenue.

Panel secretariat and administration

15. Inland Revenue's Technical Standards Unit will take on a secretariat role to support the Panel. The Secretariat will undertake administrative functions and will maintain a database and website dedicated to the process.

16. Technical Standards is an Inland Revenue business unit comprising solicitors, technical advisors, business analysts and process design specialists.

17. An internet website will provide the main avenue for new issues to be submitted by taxpayers and agents, and for progress of each issue to be tracked. This website can be viewed at **www.rewriteadvisory.govt.nz** Issues can also be submitted by post to the Panel at the address given at paragraph 29.

18. This website will contain:
    - a description of the process
    - details of the Panel members
    - register of issues and their status
    - an online submission form.

19. Recommendations of the Panel and outcomes of the process will be communicated to the person raising the issue, on the website and through other channels, depending upon the significance of the issue.

20. "Unintended legislative change issue" – this term is used in this Panel Statement to refer to the identification of an instance when the meaning of a provision in the ITA 2004 has potentially changed from the meaning of the corresponding provision in the ITA 1994, and is not included in the intended policy changes listed in Schedule 22A of the ITA 2004.

21. The complexity of each issue and the volume of issues will influence the length of time needed to complete the process. It is acknowledged that timeliness is important and issues raised through this process will be treated expeditiously.

22. Issues raised by Inland Revenue will also follow this process.

The process

23. This section covers the following:
    - overview
    - submitting issues
    - content/form of submissions
    - Inland Revenue analysis
    - the Panel process
    - outcomes and communication
    - penalties and interest
    - disputes and rulings processes

Overview

24. A potential unintended legislative change issue can be referred to the Panel Secretariat. The Secretariat will refer all issues to the Panel and to Inland Revenue officials for their analysis and comment.

25. Following Inland Revenue analysis, a report will be forwarded to the Panel to consider whether there is an unintended legislative change and to recommend a course of action. A copy of Inland Revenue's report will be made available to the submitter for their consideration and comment. The submitter may forward any comments to the Secretariat within 10 working days. If time is an issue, this should be raised with the Secretariat.

26. Simple changes such as typographical errors or incorrect cross references will also be brought to the Panel's attention, but the Panel will not formally review these.

27. Once the Panel has considered an issue the Panel will make a recommendation to the Government. The Government will then determine the appropriate response to an unintended legislative change.

Submitting issues

28. Potential unintended legislative change issues will come from a variety of sources, including:
    - Inland Revenue
    - taxpayers/agents
    - ICANZ or NZLS tax committees
    - any other interested persons.

29. The Panel wants to ensure submitting issues for its consideration is straightforward. An issue can be submitted in the following ways:
    - by using the online form on the Rewrite Advisory Panel website—**www.rewriteadvisory.govt.nz**
    - by posting the appended form to:

      Rewrite Advisory Panel Secretariat
      PO Box 2198
      WELLINGTON
    - through the Tax Committees of ICANZ and NZLS
    - through the websites of ICANZ and NZLS.

30. When received, each issue will be registered by the Secretariat, and an acknowledgement sent to the submitter. Concurrently the issue will be sent to the Panel.

31. If a duplicate issue is received, the Secretariat will notify the submitter that the issue has already been raised and advise the status of the original issue. The Panel will be advised of duplications.

Content/form of submissions

32. Each submission should include:
    - the section reference under the ITA 2004

- the corresponding section reference under the ITA 1994
- a brief interpretation of the ITA 1994 (or earlier legislation)
- a brief interpretation of the corresponding provision under the ITA 2004
- a reference to any policy and practice under the ITA 1994 (or earlier legislation)
- the name and contact details of the submitter.

33. Additional documentation may also be included to support your submission.

34. A form for submissions is appended to this Panel Statement (see Appendix).

Inland Revenue analysis

35. The Secretariat will refer every issue to Inland Revenue's Technical Standards Unit for analysis.

36. Inland Revenue advise that their analysis will involve researching the provision affected, both in its pre and post rewrite form, identifying the interpretation of the corresponding provision prior to the rewrite and establishing a view as to whether or not there has been a change in the law.

37. Inland Revenue officials will also highlight their preferred means of resolving the matter.

The Panel process

38. Submissions will be referred by the Secretariat to the Panel in a timely manner, along with a report from Inland Revenue officials setting out their analysis, options and recommendation for dealing with the issue—the timing of this will depend on the complexity of the issue.

39. The Secretariat will forward a copy of Inland Revenue's report to the submitter and the submitter may make further comment to the Secretariat within 10 working days from the date the report is sent.

40. The Panel will meet as required to consider the issues and, in particular, whether there has been an unintended change in the law through the rewrite process.

41. If the Panel considers there has been an unintended change in the law, the Panel will make a recommendation to the Minister of Revenue as to the appropriate course of action, for example, whether the ITA 2004 should be amended or whether the change should be retained.

42. In some cases urgency may be required, for example, in the case of a dispute with Inland Revenue over the interpretation of the ITA 2004. If this is the case, the Panel is prepared to consider the matter expeditiously. Any need for urgency will need to be brought to the Secretariat's attention at the time an issue is submitted. In such cases it may be necessary to depart from the process outlined above.

Outcomes and communication

43. When an unintended legislative change is confirmed by the Panel, the Panel will make a recommendation to the Government as to the preferred resolution. However, ultimately it is the Government's decision.

44. The Panel anticipates that the Government will decide to either:

    - amend the ITA 2004 to reinstate the outcome given under the ITA 1994, or
    - permit the unintended change to be retained in the legislation.

45. Given the circumstances of the case, the Government may also decide if the issue merits wider consultation, under the generic tax policy process, before any amendment is undertaken. The Government will also decide the application date of any amendment, and whether the Act will be amended retrospectively.

46. Submitters will be notified directly of the outcome. The Panel's website will also record the outcome.

47. Inland Revenue will also publish the outcome of issues reviewed by the Panel in Inland Revenue's *Tax Information Bulletin.*

Penalties and interest

48. This process does not remove the need for taxpayers to take care in preparing tax positions. The following paragraphs summarise the position proposed by the Commissioner.

49. In most cases when interpreting a rewritten provision under the ITA 2004, taxpayers will be able to rely on existing interpretations of the corresponding ITA 1994 provision. If a taxpayer has taken an acceptable tax position, a taxpayer will not be liable to a shortfall penalty.

50. If the meaning of the ITA 2004 is unambiguous, it should be applied, even if it appears that there has been an unintended change.

51. However, if a taxpayer has not taken an acceptable tax position then a shortfall penalty will be imposed.

52. Inland Revenue advises that it will provide more detail on the treatment of penalties and interest in a standard practice statement that will be published in their *Tax Information Bulletin.*

Disputes and rulings processes

53. The unintended legislative change process set out in this Panel Statement does not affect the operation of the disputes process or the rulings process. The unintended legislative change process sits alongside those statutory processes.

54. In each case, taxpayers and Inland Revenue will need to consider whether commencement of a dispute could be delayed or continuation of a dispute be suspended while an issue is referred through this process. This process does not override existing legislative time-bar or response periods.

55. Please note the ITA 2004 contains savings provisions that allow existing binding rulings to continue to apply.

APPENDIX

Income Tax Act 2004 – Rewrite Advisory Panel Secretariat

Submission of unintended legislative change issue

Name of submitter	
Contact person	
Mailing address	
Phone	
Email address	
Brief description of issue	
Section/provision of the Income Tax Act 2004	
Your interpretation under the Income Tax Act 2004	
Section/provision of the Income Tax Act 1994 (or earlier Act) and your interpretation	
Policy and practice under the Income Tax Act 1994 (or earlier Act)	
Please indicate if urgency is required and give reasons	

Note: Supporting or explanatory material may be attached.

REGULAR FEATURES

DUE DATES REMINDER

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

September 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

30 GST return and payment due

These dates are taken from Inland Revenue's *Smart business tax due date calendar 2004–2005.* The calendar reflects the due dates for small employers only—less than $100,000 PAYE and SSCWT deductions per annum

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

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

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

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

Name ______________________________

Address ______________________________

____

	Draft standard practice statement	*Comment deadline*
☐	ED0064: Late filing penalty	31 August 2004

Items are not generally available once the comment deadline has passed

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

Put stamp here

The Manager (Field Liaison)
Adjudication and Rulings
National Office
Inland Revenue Department
PO Box 2198
Wellington

INLAND REVENUE NATIONAL OFFICE PO BOX 2198 WELLINGTON TELEPHONE (04) 498 5800