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THIS MONTH'S OPPORTUNITY FOR YOU TO COMMENT

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

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

The following draft items are available for review/comment this month, having a deadline of 30 April 2005.

Ref.	Draft type	Description
IS0033	Interpretation statement	Company deductions
QB0030	Question we've been asked	Commissioner's power to issue a replacement ruling that operates retrospectively

Please see page 30 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**

BAD DEBTS – WRITING OFF DEBTS AS BAD FOR GST AND INCOME TAX PURPOSES

PUBLIC RULING – BR PUB 05/01

Note (not part of ruling): This ruling is essentially the same as public ruling BR Pub 00/03 published in *Taxation Information Bulletin* Vol 12, No 5 (May 2000), and public ruling BR Pub 96/3A which was published in *Taxation Information Bulletin* Vol 8, No 10 (December 1996). BR Pub 00/03 applied until 31 March 2004. Some minor changes have been made to the description of the arrangement in the new ruling. BR Pub 05/01 applies from 1 April 2004 for an indefinite period.

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

Taxation Laws

All legislative references to the Income Tax Act are to the Income Tax Act 1994 and all references to the GST Act are to the Goods and Services Tax Act 1985.

This Ruling applies in respect of section DJ 1(a)(iii) of the Income Tax Act and section 26(1)(c) of the GST Act.

The Arrangement to which this Ruling applies

The Arrangement is the writing off of a debt (or part of a debt) as a bad debt, for income tax and/or GST purposes, in the following circumstances:

- An existing debt is owing to the taxpayer; and
- The debt is adjudged as "bad" when a reasonably prudent commercial person would conclude that there is no reasonable likelihood that the debt will be paid; and
- The bad debt is "written off" in accordance with the accounting and record keeping systems maintained by the taxpayer if:
  - in the case of a large corporate or business taxpayer who maintains a computerised bad debts system, by an authorised person making the appropriate entry in that system recording the debt as written off; or
  - in the case of a company (other than one falling within the above class), by an executive or other responsible officer of the company with the authority to do so, making the appropriate bookkeeping entries in the books of account of the company recording the debt as written off; or
  - in the case of a taxpayer (other than a company) that maintains double-entry accounts, by an authorised person making the appropriate bookkeeping entries in the books of account of the business recording the debt as written off; or
  - in the case of a taxpayer who is an unincorporated sole trader or small unincorporated business taxpayer who does not maintain double-entry accounts, by the taxpayer noting, in the bookkeeping records of the taxpayer setting out the amount owed by the bad debtor, that the debt has been written off, and the date of the writing off.

This Ruling does not consider or rule on the tax treatment of arrangements to which the avoidance provisions in the Income Tax Act or the GST Act are applicable.

How the Taxation Laws apply to the Arrangement

The Taxation Laws apply to the Arrangement as follows:

- An income tax deduction is permitted in terms of section DJ 1(a)(iii) of the Income Tax Act.
- A deduction from GST output tax is permitted in terms of section 26(1)(c) of the GST Act.

The period for which this Ruling applies

This Ruling will apply from 1 April 2004 for an indefinite period.

This Ruling is signed by me on the 3rd day of March 2005.

Martin Smith
Chief Tax Counsel

COMMENTARY ON PUBLIC RULING BR PUB 05/01

This commentary is not a legally binding statement, but is intended to provide assistance in understanding and applying the conclusions reached in Public Ruling BR Pub 05/01 ("the Ruling"). The Ruling applies in respect of section 26(1)(c) of the GST Act 1985 and section DJ 1(a)(iii) of the Income Tax Act 1994. By way of the savings provisions in sections YA 3 and YA 4 of the Income Tax Act 2004, the Ruling and hence the reasoning in this commentary continue to apply in respect of the corresponding provision in the Income Tax Act 2004, section DB 23(1)(a), from the date the 2004 Act comes into force (this is dealt with in greater depth on page 17).

Background

The Income Tax Act and the GST Act allow taxpayers and/or registered persons a deduction for bad debts if certain criteria are met. Criteria common to both Acts are the requirements that a debt must be both bad and written off before any deduction can be made. The issues that arise when claiming a bad debt deduction are: when a debt is considered bad, and what is required to write off a debt as bad.

These issues were previously dealt with in public ruling BR Pub 00/03 and that public ruling is replaced by this Ruling from 1 April 2004. The previous ruling concluded that a debt (or part of a debt) must be both bad and written off before any person can claim an income tax deduction or a deduction from GST output tax (assuming that other legislative requirements in the GST Act and the Income Tax Act are also satisfied).

The Ruling sets out the tests to apply in deciding whether or not a debt is "bad" and what is sufficient "writing off" of a bad debt. However, the Ruling does not apply to arrangements to which the tax avoidance provisions apply.

Legislation – Income Tax Act 1994

Section BD 2(1)(b) allows a deduction for any expenditure or loss incurred by a taxpayer in deriving the taxpayer's gross income or necessarily incurred in carrying on a business for the purpose of deriving the taxpayer's gross income.

However, notwithstanding section BD 2(1)(b), section DJ 1(a) prohibits the deduction of bad debts, except where and to the extent that a number of requirements are met.

Section DJ 1

The relevant part of section DJ 1 in force at the date of commencement of this Ruling (1 April 2004), states:

Except as expressly provided in this Act, no deduction is allowed to a taxpayer in respect of any of the following sums or matters:

(a) Bad debts, except where and to the extent that,—

(i) In the case of a debt which is an amount owing to the taxpayer in respect of a financial arrangement where the accrual rules apply to the taxpayer in respect of the financial arrangement, a deduction is allowed under either section EH 54 or EH55; and

(ii) In any case other than that of a debt which is an amount owing to the taxpayer in respect of a financial arrangement where the accrual rules apply to the taxpayer in respect of the financial arrangement, the bad debt is not a loss of capital subject to section BD 2(2)(e); and

(iii) The debt is actually written off as a bad debt by the taxpayer in the income year; and

(iv) In any case where—

(A) The taxpayer is a company; and

(B) The debt is owed by a company (referred to in this subparagraph as the "debtor"); and

(C) The application of the amount giving rise to the debt is taken into account in calculating a net loss (referred to in this subparagraph as the "resultant loss") of the debtor or any other company funded (directly or indirectly) by the debtor; and

(D) Any one or more amounts have been offset under section IG 2 of this Act or section 191A of the Income Tax Act 1976 by the taxpayer (or by any other company which is at any time in the income year in which the resultant loss is incurred in the same group of companies as the taxpayer), in any income year commencing on or after 1 April 1993 and preceding the income year in which the bad debt is written off, in respect of the resultant loss,—

the debt exceeds the aggregate of the amounts so offset.

Section DJ 1(a)(iii) sets out one of the requirements to be satisfied for a bad debt deduction to be allowed, namely that the debt must have been actually written off as a bad debt by the taxpayer in the income year. It is this part of the income tax bad debt deduction provision that is addressed in the Ruling and discussed more fully in the *Application of the Legislation* section of this commentary.

Section DJ 1(a)(iii) was amended (effective from 24 October 2001, with application to the 2002–03 and subsequent income years) so that when a debt is actually written off as a bad debt by the taxpayer in the income year, there is no longer an express requirement that it be "proved to the satisfaction of the Commissioner". This change was considered in a Government discussion document titled *Legislating for Self-Assessment of Tax Liability*, first published in August 1998. The discussion document states that the Commissioner's administrative discretions such as those found in section DJ 1(a)(iii) of the ITA are incompatible with a self-assessment regime. Administrative discretions are already embodied in the Commissioner's general administrative and collection powers, such that specified administrative discretions are superfluous. The discussion document states that the Government's view is that discretions of this type could be removed without changing the effect of the law. Therefore, it is considered that this legislative change does not impact on the issues dealt with in this public ruling in deciding whether or not a debt is bad and what is sufficient to write off a debt as bad.

Other section DJ 1(a) requirements (in summary form) that must also be satisfied are:

- Section DJ 1(a)(i) – if the debt is an amount owing under a financial arrangement and the accrual rules apply to the taxpayer in respect of the financial arrangement, a deduction is allowed under either section EH 54 or EH 55. However, any such bad debt deduction is still conditional on satisfaction of the section DJ 1(a)(iii) requirement that the debt has been actually written off as a bad debt by the taxpayer in the income year.
  (**Note:** The accrual rules have been rewritten by the Taxation (Accrual Rules and Other Remedial Matters) Act 1999. Section DJ 1 as set out above has also been amended with effect from 20 May 1999 to take account of consequential changes made by that Act. A more detailed discussion about bad debts that arise where the accrual rules apply, and the changes made by the above Act, appears on pages 15 to 17 of this commentary); and
- Section DJ 1(a)(ii) – If the debt is not an amount owing in respect of a financial arrangement to which the accrual rules apply, the bad debt must not be a loss of capital that is subject to section BD 2(2)(e); and
- Section DJ 1(a)(iv) –
  - If the taxpayer is a company and the debt is owed to that company by another company ("the debtor") and
  - The amount giving rise to the debt is taken into account in calculating a loss incurred by the debtor or any other company funded by the debtor; and
  - Any amounts of that loss have been offset under the group company loss offset provisions in section IG 2, or section 191A of the Income Tax Act 1976, by the taxpayer (or any other company in the same group as the taxpayer in the year the loss is incurred), in any income years from 1993–94 and preceding that in which the bad debt is written off, –

  the deduction allowed for the bad debt is the amount by which the debt exceeds the total amounts offset.

Bad debts recovered

Under section CE 1(1)(d), amounts received by a person on account of a bad debt for which a deduction has previously been allowed to the person are included as gross income of the person.

Legislation – GST Act

Section 26

Sections 26 and 26A of the GST Act state:

26. Bad debts—

(1) Where a registered person—

(a) Has made a taxable supply for consideration in money; and

(b) Has furnished a return in relation to the taxable period during which the output tax on the supply was attributable and has properly accounted for the output tax on that supply as required under this Act; and

(c) Has written off as a bad debt the whole or part of the consideration not paid to that person,-

that registered person shall make a deduction under section 20(3) of this Act of that portion of the amount of tax charged in relation to that supply as the amount written off as a bad debt bears to the total consideration for the supply:

Provided that where goods are supplied under a hire purchase agreement to which the Hire Purchase Act 1971 applies, the registered person shall only make a deduction under section 20(3) of this Act of the tax fraction (being the tax fraction applicable at the time that the hire purchase agreement was entered into) of that portion of the amount written off as a bad debt as the cash price bears to the total amount payable under the hire purchase agreement:

[**Note:**The proviso to subsection (1) is to be amended, as from 1 April 2005, by section 139 Credits Contracts and Consumer Finance Act 2003 (2003 No 52) by omitting the words "to which the Hire Purchase Act 1971 applies". See sections 141 to 143 of that Act as to the transitional provisions.]

(1AA) Subsection (1) also applies if a registered person sells a debt to a third party and then reacquires the debt.

(1AB) A registered person who is required to account for tax payable on a payments basis under either section 19 or section 19A must apply this section only to supplies made by the person to which any one of sections 9(2)(b), 9(3)(b) and 26A applies.

(1A) Where a registered person has, in respect of the supply by that registered person of any contract of insurance (being a supply charged with tax pursuant to section 8(1) of this Act),—

(a) Paid any amount to the Earthquake and War Damage Commission pursuant to the Earthquake and War Damage Act 1944 or to the New Zealand Fire Service Commission pursuant to the Fire Service Act 1975; and

(b) Sought to recover that amount, together with the consideration for that supply, from the recipient of that supply; and

(c) Written off as a bad debt the whole or part of that amount not paid to that registered person,—

that registered person shall make a deduction under section 20(3) of this Act of the tax fraction of that amount or that part of that amount written off.

(2) Where any amount in respect of which a deduction has been made in accordance with subsection (1) of this section is at any time wholly or partly recovered by the registered person, that portion of the amount of the deduction allowable under subsection (1) of this section as the amount of the bad debt recovered bears to the bad debt written off shall be deemed to be the tax charged in relation to a taxable supply made during the taxable period in which the bad debt is wholly or partly recovered.

26A Factored debts—

A registered person who sells a debt to a third party must pay tax on the remaining book value of the debt on the date that the debt is sold if the registered person accounts for tax payable on a payments basis.

Section 26 is the main provision applying to bad debts for GST purposes. The section applies to registered persons who account for GST on an invoice or hybrid basis. It also applies to registered persons who account for GST on a payments basis when the relevant supply is by way of a hire purchase sale (section 9(3)(b)), a door-to-door sale (section 9(2)(b)), or where a registered person sells a debt to a third party (section 26A).

Section 26(1) allows a registered person to make a deduction from output tax for that portion of the amount of tax charged in relation to a supply as the amount written off as a bad debt bears to the total consideration for the supply. To claim the deduction, the registered person must satisfy a number of criteria. Section 26(1)(c) sets out one of these, namely that the registered person must have written off as a bad debt the whole or part of the consideration not paid to that person.

The other section 26(1) criteria (in summary form) also to be satisfied are that the registered person must have:

- Section 26(1)(a) – made a taxable supply for consideration in money (from which the bad debt arose); and
- Section 26(1)(b) – furnished a return in relation to the taxable period during which the output tax on the supply was attributable, and properly accounted for the output tax on the supply.

A proviso is effective if goods are supplied under a hire purchase agreement as defined in the Hire Purchase Act 1971 (or as defined in the GST Act from 1 April 2005). In this case the registered person makes a deduction from output tax of the tax fraction (being the tax fraction applicable at the time the hire purchase agreement was entered into) of that portion of the amount written off as a bad debt as the cash price bears to the total amount payable under the hire purchase agreement.

A special provision exists for registered persons who supply contracts of insurance relating to earthquakes, and fires (see section 26(1A)).

Application of the legislation

As indicated earlier, criteria common to both the Income Tax and GST Acts are the requirements that a debt must be both bad and actually written off before any deduction can be made. This section of the commentary is therefore divided into two parts, discussing firstly the tests to apply in deciding whether or not a debt is "bad", and secondly what is sufficient "writing off" of a bad debt.

First requirement – debt must be "bad"

The relevant time of inquiry as to whether a debt is bad is the time that the decision is made to write off the debt.[1] A debt must be "bad" before it can be written off and before any deduction can be claimed for that debt. Whether or not a debt (or part of a debt) is bad is a question of fact to be determined objectively. A debt becomes a bad debt when a reasonably prudent commercial person would conclude that there is no reasonable likelihood that the debt will be paid. The onus of proof is on the taxpayer. The standard to which the test must be proved is on the balance of probabilities: see *Budget Rent A Car Ltd v CIR* (1995) 17 NZTC 12,263, at page 12,269; *Case N69* (1991) 13 NZTC 3,541, at page 3,548; *Graham v CIR, Edwards Graham Ltd & Edwards v CIR* (1995) 17 NZTC 12,107, at page 12,111; *Case T27* (1997) 18 NZTC 8,188, at page 8,194; *Case W3* (2003) 21 NZTC 11,014 at page 11,029.

The expired public ruling refers to the "reasonably prudent **business** person" whereas this public ruling refers to the "reasonably prudent commercial person". This change adopts the wording of the High Court case *Budget Rent A Car*. The term "**commercial** person" refers to people directly involved in commerce or business, and would also include people who have professional knowledge of commerce such as directors of a company, a loans manager of a bank, accountants, a business consultant, and lawyers with business experience. The term "commercial person" appears to be a wider term such that it includes "business persons" as well as professionals with knowledge of commerce.

At the time of deciding whether a debt is bad, a person will therefore need to have sufficient information to enable a reasonably prudent commercial person to form the view that there is no reasonable likelihood that the debt will be paid. This requires a bona fide assessment based on sound commercial considerations, that the debt is bad. Sound commercial judgment cannot be exercised in relation to determining that a debt is bad if there is still a real and continuing dispute in as to whether or not the debt is payable.[2] In such a situation, a taxpayer cannot at that point in time, on any objective view, come to the conclusion that the debt was bad. The debt must be more than doubtful. Determining the question of fact as to whether a debt is bad depends on the circumstances surrounding any particular case. While no factor is decisive in itself, factors that are likely to be relevant in considering whether a debt is bad include[3]:

- The length of time a debt is outstanding—the longer a debt is outstanding the more likely it is that a reasonably prudent commercial person would consider the debt to be bad. This will of necessity vary depending upon the amount of the debt outstanding and the taxpayer's credit arrangements (eg 90, 120 or 150 days overdue). However, a debt will not be considered bad merely because a set period of time for payment has elapsed with no payment or contact having been made by the debtor. Similarly, a debt may have only been outstanding for a short period and still be regarded as bad where other evidence exists that the debt will not be collected;
- The efforts that a creditor has taken to collect a debt—the greater the extent to which a person has tried (unsuccessfully) to collect a debt, the more likely it is that a reasonably prudent commercial person would consider the debt to be bad;
- Other information obtained by a creditor—a creditor may have obtained particular information about a debtor, eg through business or personal networks, that would be a factor in leading a reasonably prudent commercial person to conclude that a debt is bad. For example, a creditor may know that the debtor is in financial difficulties and has defaulted on debts owed to other creditors;
- A debt may be considered bad if the debtor has died leaving no, or insufficient, assets out of which the debt may be satisfied;
- The debtor cannot be traced and the creditor had been unable to ascertain the existence of, or whereabouts of, any assets against which action could be taken;
- Where the debt has become statute-barred and the debtor is relying on this defence (or it is reasonable to assume that the debtor will do so), for non-payment;
- If the debtor is a company, it is in liquidation or receivership and there are insufficient funds to pay the whole debt, or the part claimed as a bad debt.

A debtor does not need to be insolvent for a debt to be bad (although this will often be the case).

[1] *Case 45/93* 93 ATC 486; AAT *Case 9093* (1993) 27 ATR 1022.

[2] *Case 45/93 93* ATC 486; AAT *Case 9093* (1993) 27 ATR 1022. Also see Australian Taxation Office Goods and Services Tax Ruling GSTR 2000/2 paragraphs 37 and 38

[3] Bullet points 4 – 7 are from Australian Taxation Office Tax Ruling 92/18 paragraph 31.

Taxpayer's opinion

A debt becomes a bad debt when a reasonably prudent commercial person concludes that there is no reasonable likelihood that the debt will be paid. In many instances, a taxpayer's considered opinion will suffice.

However, the Commissioner also recognises that taxpayers have a financial interest in treating a debt as bad. Writing off a debt as bad entitles a taxpayer to:

- A deduction in calculating income for income tax purposes, worth up to 39% of the debt, depending on the taxpayer's marginal income tax rate.
- A GST deduction from output tax of the tax fraction of the debt.

Because of this, the Commissioner may inquire into the decision to treat a debt as bad in the course of tax audits or other enquiries. It is desirable, therefore, that taxpayers document and retain evidence in relation to their decisions to treat debts as bad to show that they made reasonable decisions. Documentation may include noting down the information from which the decision was made that the debt was bad, and keeping copies of any correspondence relating to the debt. It should be remembered that the onus of proof is on the taxpayer and the standard is on the balance of probabilities.

Information required

The amount of information required to decide whether a debt is bad depends on the particular circumstances of each case. If the amount involved is small, a reasonably prudent commercial person is likely to make limited enquiries and take limited recovery action. Particular knowledge or information obtained by a taxpayer may also reduce the need for enquiry. In the final analysis, however, the test is always whether the taxpayer has sufficient information to reasonably draw the conclusion that there is no reasonable likelihood that the debt will be paid, even if further or any recovery actions were to be taken.

Recovery steps taken

A creditor is likely to have taken legal steps to try to recover the debt in most cases before a deduction for a bad debt is made, although it is not a requirement that such action be taken before a decision is made that a debt is bad. However, it is through taking recovery action that most creditors will form an opinion as to whether a debt is bad. While recovery action is being taken, a debt can only be considered bad to the extent that a reasonably prudent commercial person would consider there is no reasonable likelihood that the debt will be paid.

To establish that there is no reasonable likelihood that the debt will be paid, a reasonably prudent commercial person would, in most situations, take steps to recover the debt instead of simply writing it off. This may encompass a range of actions including legal proceedings. The appropriate steps undertaken will vary according to the size of the debt and the resources available to the creditor to pursue the debt. A creditor might not take any steps in attempting to recover the debt where the information suggests that there is no hope of payment. The steps taken to recover the debt would generally be expected to include one or more of the following, depending upon the circumstances[4]:

- Reminder notices issued and telephone, mail or email contact is attempted;
- Allow a reasonable period of time to elapse since the original due date for payment of the debt. This will vary depending upon the amount of the debt outstanding and the taxpayer's credit arrangements.
- Formal demand notice is served;
- Commencement of legal proceedings for debt recovery;
- Judgment entered against the delinquent debtor;
- Execution proceedings to enforce judgment;
- The calculation and charging of interest is ceased and the account is closed (a tracing file may be kept open; also, in the case of a partial write-off, the account may remain open);
- Valuation of any security held against the debt;
- Sale of any seized or repossessed assets.

While the above factors are indicative of the circumstances in which a debt may be considered bad, ultimately the question is one of fact and will depend on all the facts and circumstances surrounding the transactions.

In some instances, taking recovery action may carry with it the reasonable expectation of recovery of some part of the amount involved. However, this will not always be the case. The decision to take recovery action and the extent of that action will depend on the circumstances surrounding any particular case. In some cases, the creditor may take no or only limited recovery action because enough information is held to form a reasonable view that the debt is bad. The amount of information needed depends on the circumstances.

Conversely, the creditor may take recovery action even when a reasonable view has been formed that the debt is bad. For a number of reasons the creditor might take recovery action even when it is believed that there is no reasonable likelihood that the debt will be recovered. This may be the case, for example, when the creditor has a policy of pursuing debtors to a certain extent to discourage customers defaulting on debt.

[4] See Australian Taxation Office Goods and Services Tax ruling GSTR 2000/2 paragraphs 41 and 42 and Australian Taxation Office Tax Ruling 92/18 paragraph 32.

Provision for doubtful debts

Persons in business who provide credit often find it prudent to make some provision for the likelihood that some of their debtors will not pay. This allowance is generally calculated by estimating a percentage on the basis of past history, and applying that percentage to the total amount of debts owed to the business at balance date.

Bad debts are individually identifiable debts that are unlikely to be recovered (in practical terms). The provision for doubtful debts is an estimate of the amount that will become bad debts in the future. The Income Tax Act and the GST Act do not allow any deduction for provisions for doubtful debts.

Debts that are partially bad

In some cases there may be no reasonable expectation that the debt will be fully recovered, but there may be a reasonable expectation of partial recovery. In this case the part that the creditor has no reasonable expectation of recovering is a bad debt. It is only that part of the debt that the creditor is entitled to write off as bad and claim as a deduction for income tax and GST purposes.

Examples of when a debt is bad or is not bad

Example 1

A supplier has supplied goods on credit to Mr B. Mr B owes the supplier $2,000 for the goods. The supplier knows that Mr B has left town, and that mail addressed to him is returned marked "Gone, no address".

In this case it is reasonable to assume that the debt will not be recovered. The money owed by Mr B is a bad debt.

Example 2

C owes $100,000 to a company. The credit controller for the company has considered the likelihood of default on every loan currently owing to the company. The credit controller has estimated the likelihood of default for C to be 5%, and wants to know if the company can consider $5,000 of that loan (5% of the $100,000 owing) to be a bad debt.

Making an estimate of the likelihood of default on debts is not sufficient for a debt (or a percentage thereof) to be bad. It is not reasonable to assume that the debt is bad.

Example 3

A local dairy has supplied $64 worth of bread and cigarettes to Mrs D on credit. Mrs D used to call into the shop every other day, but has not called into the shop for eight weeks and the dairy has heard that someone else is living in the house Mrs D used to rent. The $64 is still owing.

Given the relatively small amount owing and the information known to the dairy, it is reasonable for the dairy to make no further enquiries. On the basis of the dairy's information, it can be assumed that the money is unlikely to be recovered. It is a bad debt. However, if the sum involved was somewhat larger, it may be reasonable to expect the dairy to make some further enquiry.

Example 4

A solicitor has done work for Mr O and billed him for $1,700. The solicitor is on the board of trustees of the school attended by Mr O's children. The solicitor has sent out a number of reminder bills because the bill is four months overdue, but has had no response. Several of the solicitor's friends and associates have mentioned that Mr O is in financial difficulty and has had one of his vehicles repossessed. The solicitor's office clerk has noted that Mr O's name has been cited in the *Gazette* several times over recent months in respect of court action for unpaid debts.

It is reasonable for the solicitor to characterise Mr O's debt as a bad debt.

Example 5

A debtor of Mr F is a company in liquidation. Mr F has given the liquidator notice of a debt of $10,000 owed for goods and services supplied. Mr F is an unsecured creditor. The liquidator has held a meeting of creditors. Mr F attended the meeting and received formal notice of the outcome of the meeting. The liquidator has stated that unsecured creditors will probably receive something between 45 and 50 cents in the dollar.

It is reasonable for Mr F to assume that $5,000 of the total debt is bad. He is entitled to write off that part of the debt that is bad in the income year in which he received the formal notice, and to claim a deduction for income tax and GST purposes.

Example 6

The same facts exist as in Example 5, but at a later date Mr F receives a letter from the liquidator who advises that the estimate of the likely recovery has been revised. It is now expected that unsecured creditors will be paid between 70 and 75 cents in the dollar.

This does not affect the answer given above in Example 5. Also, it has no effect on Mr F's GST return or income tax return if Mr F has claimed a deduction for the bad debt. If at any stage Mr F receives payment of any part of the 50 cents in the dollar written off, Mr F must:

- Include it as gross income in the income tax return for the year in which it is received (this will give rise to an income tax liability unless there are losses to offset against it, and may give rise to a provisional tax liability, depending on the taxpayer's circumstances); and

- Account for GST on the amount recovered in the same proportion as Mr F was allowed a deduction from output tax when the bad debt was written off.

Second requirement – debt must be "written off"

The Income Tax Act and the GST Act allow taxpayers and/or registered persons deductions for writing off bad debts. It is not enough that a debt is bad: the bad debt must also be actually written off. Writing off the bad debt is important because this will fix the time at which the deduction can be made. Note that there is no requirement that a debt be written off in the year it becomes bad. As Tompkins J in the High Court decision of *Budget Rent A Car Ltd v CIR* (supra) at 12,271 stated:

> A debt is not normally deductible. It does not become a deductible debt if and when it becomes a bad debt. It becomes a deductible debt, if it has been incurred in the production of assessable income, when it is written off. It is the writing off that converts the debt into a deductible debt. It follows that the crucial time is the time of the writing off, not the time the debt becomes a bad debt. It also follows that the income year referred to in s 106(1)(b) is not the year the debt became bad. In my view, the income year referred to is the year during which the bad debt was "actually written off".
>
> There is no provision in the Act that requires the bad debt to be written off in the year the debt became bad. Had that been the intention of the legislature, it would have said so ...

Barber DJ in the Taxation Review Authority discussed the requirement to write off bad debts in *Case N69* (1991) 13 NZTC 3,541. Barber DJ said at 3,547:

> I consider it elementary that the writing off of a debt as bad requires something more than the mere recognition by the taxpayer, or one or more of its executives, that a debt is unlikely to be paid. It could be reasoned that only a decision of the taxpayer to write off a debt is needed, subject to the debt being bad. However, I consider that, in terms of sec 106(1)(b), book-keeping steps must also be taken to record that the debt has been written off. Desirably, the steps would comprise a directors' resolution, if the taxpayer is a corporate, and appropriate book-keeping entries. However, it would be adequate for a responsible officer or executive of a corporate or business to merely make the appropriate book-keeping entries if he or she has that authority. An unincorporated sole trader or small unincorporated business would not, of course, have a directorate so that book entries by the trader or his or her manager will suffice. In my view, it is not possible to write off a debt as bad without the making of authorised journal entries in the books of account of the business.

In *Case T48* (1998) 18 NCTC 8,325 the Taxation Review Authority held that for a private individual trader, as distinct from an incorporated company, words on ledger cards such as "written off" with the relevant date are sufficient to indicate that the debt had been actually written off as bad. The taxpayers did not have to meet any other bookkeeping requirements.

Taxpayers must therefore be able to show clearly that the debt has been actually written off as bad rather than just making a decision in their mind. To meet the legislative requirement, there must be something written down in the books of account of the business stating that the debt is written off. Case law indicates that the minimum writing requirements to satisfy the *actually written off as bad* test may vary for different classes of taxpayer, based on the differing nature and level of sophistication of the taxpayer's accounting records. However, no matter what form a taxpayer's books of account or accounting records may take, those existing in respect of a debt owed by a bad debtor must record that the taxpayer, or an authorised person on behalf of the taxpayer, having decided the debt is bad, has written off the debt accordingly. It is the writing off of the bad debt which converts it into a deductible debt.

What will be sufficient to meet the *written off* test for various classes of taxpayer follows. The classes and the writing requirements are based largely on *Case N69, Case T48* and the earlier *Case P53*. The bad debt is "written off" in accordance with the accounting and record keeping systems maintained by the taxpayer if:

- in the case of a large corporate or business taxpayer who maintains a computerised bad debts system, by an authorised person making the appropriate entry in that system recording the debt as written off; or
- in the case of a company (other than one falling within the above class), by an executive or other responsible officer of the company with the authority to do so, making the appropriate bookkeeping entries in the books of account of the company recording the debt as written off; or
- in the case of a taxpayer (other than a company) that maintains double-entry accounts, by an authorised person making the appropriate bookkeeping entries in the books of account of the business recording the debt as written off; or
- in the case of a taxpayer who is an unincorporated sole trader or small unincorporated business taxpayer who does not maintain double-entry accounts, by the taxpayer noting, in the bookkeeping records of the taxpayer setting out the amount owed by the bad debtor, that the debt has been written off, and the date of the writing off.

There may be very exceptional cases where less than the above writing off requirement is acceptable, such as in *Case S73*, where the taxpayer was unable to access the accounting records and a letter was sent to the Commissioner stating that the debt had been written off. Nevertheless, there remains a writing requirement in all cases.

Further details of the specific form the necessary write off of a bad debt may take in the creditor taxpayer's books are outlined in the next section of this commentary.

It is the writing off that determines the time when a deduction for a bad debt can be claimed. The necessary writing off must therefore take place before the end of the

income year or GST taxable period in relation to which the bad debt deduction is claimed. Writing off a bad debt cannot be backdated. Therefore, if there are numerous debts to review, it is important to allow sufficient time for this exercise, as well as for completing all necessary "writing off" accounting entries before the end of an income year or GST taxable period, to enable any bad debts to be deducted in that year or GST taxable period.

In all cases the business records kept by the taxpayer must comply with the requirements of section 22 of the Tax Administration Act 1994 and section 75 of the GST Act.

Accounts kept by taxpayers

Most taxpayers in business keep double-entry accounts. If a person keeps double-entry accounting records, the bad debt must be struck out of the records on which the double-entry accounts are based. If debtors' ledgers are maintained, the writing off will be able to be clearly shown by the appropriate bookkeeping entries having been made in the debtors' ledger by authorised persons. Generally, this means that the balance in the debtors' ledger for the individual debtor must be reduced by the amount of the bad debt. No matter what processes are followed in the course of preparing a person's double-entry accounts, it is the completion of the appropriate authorised entry/entries actually writing off a debt (which it has been decided is bad in accordance with the tests already outlined) that is essential to deductibility.

In cases where a taxpayer does not keep double-entry accounting records and/or does not keep a debtors' ledger, the person must write the debt off according to the form of records used. This means that whatever the form of records used, those showing the amount owed by the bad debtor must clearly record that the creditor, having made the decision that the debt is bad (in accordance with the tests already outlined), has written the debt off accordingly.

Particular examples of bad debts accepted by the Commissioner as having been written off are:

- If a taxpayer's only records of debts are copies of invoices issued, placing the invoice in a "bad debts" file and indicating on the invoice whether all or part of the invoiced amount is bad and the date, is sufficient.
- If a taxpayer's only records of debts are copies of invoices and copies of statements of account issued from a duplicate account book, marking the copy of the final statement sent out "bad debt—written off" (noting the amount of the debt that is bad and the date) is sufficient. Alternatively, it would also be sufficient for the taxpayer to place the relevant invoice in a "bad debts" file indicating on the invoice whether all or part of the invoiced amount is bad and the date this was done.

Keeping records for credit control or other purposes

For a variety of reasons, a creditor may keep a separate record of bad debts written off. For example, the records may be necessary if the creditor should ever have the opportunity of collecting the debt in the future, or the creditor may want to keep a record of problem customers to avoid future difficulties.

As long as these records are quite separate from the accounting base records they will not affect the write-off. If the creditor ceases to recognise the debt as an asset for accounting purposes by removing it from the accounting base records, it is written off.

More than one set of accounts

Some businesses have more than one set of accounts. For example, a company may prepare:

- Financial accounts for financial reporting purposes to satisfy the requirements of the Companies Act 1955 or 1993; and
- Management accounts as a basis for management decision-making and control.

The sets of accounts may be prepared in quite different ways. For example, statutory requirements are set out in the Financial Reporting Act 1993 for preparing financial reports that are not required when preparing management accounts; and management accounts may be prepared on the basis of estimates for some elements in order to provide very quick reports.

When the different sets of accounts rely on the same underlying debtor records, no difficulty arises. As long as the creditor ceases to recognise the debt as an asset for accounting purposes by removing it from the accounting base records, it is written off. However, if the debt is still recognised as an asset in the underlying records, it is not written off.

If the different sets of accounts rely on different underlying debtor records (which is very rare), the creditor should refer to the accounts that are relied on to represent the firm's financial position. For a company, these will be the accounts used to satisfy the company's financial reporting obligations under the relevant Companies Act.

Examples of when a bad debt is or is not written off

General facts

The following facts apply to all the following examples:

- The taxpayer's income tax balance date is 31 March.
- The only question is whether a debt has been written off. All other criteria are satisfied.
- The debt is for goods and services supplied for money.

- The supply has been included in the taxpayer's gross income for income tax purposes.

In the examples where the taxpayer is a GST registered person, the following additional facts apply:

- GST returns are filed on a two-monthly invoice basis.
- The supply has been included in a GST return.

Example 1

The taxpayer maintains a debtors' ledger and is not registered for GST. The debtors' ledger is updated on 31 March 2003. The entries made include the journal entry writing off the bad debt.

The bad debt is deductible in the year ending 31 March 2003.

Example 2

The taxpayer maintains a debtors' ledger and is not registered for GST. The debtors' ledger is written up on 1 April 2003. The entries written up include the journal entry writing off the bad debt.

The bad debt is deductible in the year ending 31 March 2004.

Example 3

The taxpayer does not maintain a debtors' ledger and is registered for GST. There is no indication on her underlying debtor records to show the status of the debt. She has claimed a deduction from output tax for the bad debt in her GST return for the taxable period ending 31 January 2003. That return was prepared in February 2003.

The taxpayer is not entitled to the deduction from GST output tax. She is not allowed a deduction for the bad debt in the income year ending 31 March 2003. Claiming the deduction from output tax for GST purposes is not a sufficient writing off of the bad debt.

Example 4

The taxpayer does not maintain a debtors' ledger and is not registered for GST. The taxpayer's only records of debts owing to him are copies of issued invoices. The taxpayer maintains only rudimentary books of account, and his unpaid debtors are represented by loose-leaf filing of accounts and/or invoices issued in a ring-binder file. When a debt is paid it (the account and/or invoice) is transferred to a separate file. The taxpayer ceases sending accounts for the debt in question in February 2003, putting a line across the copy of the last statement sent out in respect of the debt and marking it "Final" and leaves it in the unpaid debtors' file.

The taxpayer is not entitled to a deduction for the bad debt in the year ended 31 March 2003. Simply marking the last statement issued as "Final" and leaving it in the unpaid debtors' file does not amount to writing off of the debt.

Example 5

The taxpayer does not maintain a debtors' ledger and is not registered for GST. His only records of debts owing are copies of invoices and statements issued. In February 2003 the taxpayer became aware that a debt was bad. He stopped sending out statements for the debt and took no other action on it. In particular, he sent out no statements on the account in February and March 2003. The taxpayer continued to send out statements on all the other debts owing, including overdue accounts. The taxpayer keeps carbon copies of the statements of account in the duplicate account book from which the statements for issue are prepared. The taxpayer has tagged the final statement sent out in respect of the debt, circling the amount payable and marking it "bad debt—written off—February 2003".

The taxpayer is allowed a deduction for the bad debt in the year ending 31 March 2003. The cessation of statements of account, recorded by their absence in the duplicate account book, and the tagging and marking of the final statement, amount to writing off the debt in his accounting system.

Example 6

The taxpayer maintains a debtors' ledger and is not registered for GST. She wrote up the debtors' ledger on 31 March 2003. The entries written up include a journal entry writing off a bad debt. Her accountant prepares her accounts in June 2003. In the course of preparing the accounts, the accountant makes a general ledger entry recognising the bad debt as a result of the debtor's ledger entry made by the taxpayer on 31 March 2003.

The bad debt is deductible in the year ending 31 March 2003, because the underlying accounting record of the debt was altered to recognise the bad debt on 31 March 2003.

Example 7

The taxpayer does not maintain a debtors' ledger and is not registered for GST. Her only records of debts owing are copies of invoices issued. On 15 March 2003 she placed the invoice for the debt in question in a file marked "Bad debts" noting on the invoice next to the total amount "debt bad – filed 15/3/03". The amount of trade creditors in the taxpayer's balance sheet as at 31 March 2003 includes the bad debt. The taxpayer's profit and loss statement for the year ending 31 March 2003 includes as income the sale that has become a bad debt. The profit and loss statement does not recognise any expense for bad or doubtful debts.

The taxpayer's income tax return for the year ending 31 March 2003 includes the profit and loss statement and a "tax reconciliation statement" showing the difference between the accounting income and the amount she believes to be income for income tax purposes. The tax reconciliation statement includes a deduction for the bad debt.

The taxpayer is not allowed a deduction for the bad debt. Although the debt has arguably been written off in the underlying accounting records, she has not ceased to recognise the debt as an asset for accounting purposes.

Accrual(s) rules

General

The accruals rules in Subpart EH of the Income Tax Act provide rules for the timing and recognition of income derived and expenditure incurred in respect of "financial arrangements".

The accruals rules have been rewritten by the Taxation (Accrual Rules and Other Remedial Matters) Act 1999. The amendments made by this Act apply, in general, to financial arrangements entered into on or after 20 May 1999. The changes made in relation to the allowable deductions for bad debts are discussed later in this item. Two general changes made by the amendment Act are:

- The creation of divisions of rules, one applying to financial arrangements entered into before 20 May 1999, and those that were entered into on or after 20 May 1999. These are referred to as Division 1 and Division 2 respectively.
- Division 1 financial arrangements are referred to as coming within the *accruals rules*, while Division 2 financial arrangements are referred to as coming within the *accrual rules*.

The requirement in section DJ 1(a)(iii) that "the debt is actually written off as a bad debt by the taxpayer in the income year", must be satisfied before any deduction can be claimed for a bad debt under the accrual(s) rules (sections EH 6(4) and EH 54(1)). Accordingly, the tests used in deciding whether or not a debt is "bad" and what is sufficient "writing off" of a bad debt, apply equally to debts for which a bad debt deduction arises under the accrual(s) rules.

DIVISION 1: Financial arrangements entered into before 20 May 1999

Although the significant accrual(s) rules changes made by the Taxation (Accrual Rules and Other Remedial Matters) Act 1999 apply to financial arrangements entered into on or after 20 May 1999, the rules as they affect arrangements entered into before that date have also been rewritten. As part of this process, the accruals bad debt deduction provisions, formerly in section EH 5, have been re-enacted as section EH 6. Apart from the inclusion of headings for each subparagraph and necessary updating of some references to other new section and subsection numbers referred to, there are no wording changes between the former section EH 5 and the new section EH 6.

What is a financial arrangement?

A "financial arrangement" is widely defined and means a debt or debt instrument or an arrangement under which a person receives money in consideration for the provision of money to any person, either at a future time, or when an event occurs (or does not occur) in the future. Essentially, a financial arrangement is any transaction that involves deferral of the giving of consideration. Mortgages, bank and other loans, commercial bills, and treasury stock are examples of debt type financial arrangements.

Certain specific exceptions are created, and they are designated as "excepted financial arrangements". This category includes equity type instruments (debentures, shares), insurance contracts, employment contracts, games of chance, short term credit agreements and options. Those debts falling within the "excepted financial arrangement" definition have their deductibility as bad debts considered under section DJ 1(a).

The main type of financial arrangement, in relation to bad debts, that is excluded from the Division 1 definition of "financial arrangement", is likely to be a short-term trade credit. Short-term trade credits are an "excepted financial arrangement". "Short-term trade credit" is defined as:

.... any debt for goods or services where payment is required by the vendor—

(a) Within 63 days after the supply of the goods or services; or

(b) Because the supply of the goods or services is continuous and the vendor renders periodic invoices for the goods or services, within 63 days after the date of an invoice rendered for those goods or services:

Therefore, a short term trade credit is a debt for goods or services owed to a vendor within 63 days after supply or, where the supply is continuous, the vendor expects payment within 63 days after the date an invoice is issued for those goods and services.

Arrangements entered into before the introduction of the accruals rules are also excluded from the definition of "financial arrangement".

What this means as far as a deduction for bad debts is concerned is that the deduction for bad debts arising in respect of a short term trade credit is considered under the general bad debt deduction provision in section DJ 1(a) and not under the accruals rules' section EH 6.

Revenue bad debts

Section EH 6(1) will only apply in limited circumstances to a cash basis holder. A cash basis holder is a natural person for whom either the total value of all financial arrangements held by that person will not exceed $600,000 or the income derived during the income year from financial arrangements does not exceed $70,000. Furthermore, the difference between the income that would be returned under the accruals rules, and the income returned as a cash basis holder, must not exceed a $20,000 deferral threshold.

Section EH 6(1) permits a person to deduct an amount written off as a bad debt in respect of a financial arrangement where and to the extent that:

- The person derives gross income in respect of the financial arrangement under:
    - Section EH 1 – one of the methods of calculating accrual income; or
    - Section EH 3(4) – the adjustment required in any year when a person ceases to be a cash basis holder; or
    - Section EH 4 – the base price adjustment calculated in the year a financial arrangement matures or is transferred; or
    - Section EH 8 – the post facto adjustment for financial arrangements which have the effect of defeating the intent and application of the accruals regime; and
- The amount written off is attributable to that gross income.

In other words, a bad debt comprising income from a financial arrangement previously returned by the taxpayer under the accruals rules is allowed as a deduction under section EH 6(1).

The purpose of the base price adjustment is to ensure that all income derived and all expenditure incurred is taken account of for that financial arrangement when it is either sold, matures, is remitted, or transferred.

The post facto adjustment is used to recalculate assessable income or any loss incurred in respect of the financial arrangement using the yield to maturity method in certain circumstances where:

- any amount payable under the financial arrangement is determined, according to the terms of the financial arrangement, at the discretion of the holder or the issuer, or any other person who is an associated person of the holder or the issuer; and
- when exercising this discretion the change in the amounts payable under the financial arrangement does not reflect changes in economic, commodity, industrial or financial indices or banking or commercial rates; and
- the making of such a financial arrangement is not a generally accepted commercial practice; and
- the effect of the arrangement is to defeat the intent and application of the accruals rules.

"Yield to maturity" is a method of spreading income and expenditure over the life of the financial arrangement.

Under the Income Tax Act, where the parties to a transaction are in a close relationship with each other they are classed as associated persons: for example relatives, partnerships, and individuals that hold majority interests or voting rights in a company. Association is measured by reference to voting and, where applicable, market value interests, rather than to nominal and paid-up capital. The relationship of association is defined in section OD 7(1).

Section EH 6(4) provides that the requirement in section DJ 1(a)(iii), that "the debt is actually written off as a bad debt by the taxpayer in the income year", must still be satisfied before any deduction can be claimed.

Capital bad debts

Section EH 6(2) provides for the deduction of the capital or principal element of a financial arrangement in certain circumstances. Section EH 6(2) allows a person a deduction for an amount written off as a bad debt in respect of a financial arrangement (not being an amount deductible under section EH 6(1)) where:

- The person carries on a business comprising the holding or dealing in such financial arrangements and the person is not associated with the person owing the amount written off (see section OD 7 for test of association); or
- The financial arrangement is a trade credit and the person carries on the business of dealing in the goods or services for which the trade credit is a debt. Section OB 1 provides that "Trade credit" is defined in section EH 14 for Part EH Division 1. Section EH 14 provides that, "trade credit", in the qualified accruals rules means any debt for goods and services, other than a short term trade credit.

As with "Revenue bad debts" above, section EH 6(4) requires (through section DJ 1(a)(iii)) that "the debt is actually written off as a bad debt by the taxpayer in the income year" before any deduction can be claimed.

Security payments

Under section EH 6(3), if a person receives a security payment for a loss and a deduction is not otherwise allowable for the loss, the person may be allowed a deduction for the loss up to the amount of the security payment. The purpose of section EH 6(3) is to avoid the situation where the person is taxed on the security payment but does not receive a deduction for the loss incurred.

A "security payment" means money received by, and that is gross income of, the holder of a security arrangement for any loss suffered because that arrangement is not performed. A "security arrangement" is a financial arrangement that secures the holder against failure of a person to perform their obligations under another arrangement. That other arrangement does not need to be a financial arrangement. A payment made under a guarantee is a security payment.

DIVISION 2: Financial arrangements entered into on or after 20 May 1999

This section briefly outlines the effect of the changes made by the Taxation (Accrual Rules and Other Remedial Matters) Act 1999 in the context of deductions allowed for bad debts under the accrual rules. As stated above, the amendments apply, in general, to financial arrangements entered into on or after 20 May 1999.

Allowable deductions for bad debts

Deductions for bad debts under the accrual rules are now contained in section EH 54. Section EH 54, by and large, replicates the bad debt deduction provisions from the former section EH 5 (now re-enacted as section EH 6), while the security payments and share loss deduction provisions from these sections are now contained in section EH 55. The most significant changes as they relate to the deduction of bad debts, are:

- The cash basis threshold is increased from $600,000 to $1,000,000 and income from investments from $70,000 to $100,000. In addition, the $20,000 deferral threshold, the maximum allowable difference between the income that would be returned under the accruals rules and the income returned as a cash basis holder, has been increased to $40,000.
- There is only one excepted financial arrangement for short-term agreements for the sale and purchase of property or services, unless a person elects otherwise, and this is for those agreements where settlement or performance must occur within 93 days.
- Deductions are allowed for dealers or providers of goods and services when credit is extended under an agreement for the sale and purchase of property or services.

Revenue bad debts

Section EH 54(2) permits a person to deduct an amount written off as a bad debt in respect of a financial arrangement where and to the extent that:

- The person derives gross income in respect of the financial arrangement; and
- The amount written off is attributable to the income.

Capital bad debts

Section EH 54(3) provides for the deduction of the capital or principal element of a financial arrangement in certain circumstances. Section EH 54(3) allows a person a deduction for an amount written off as a bad debt in respect of a financial arrangement (not being an amount deductible under section EH 54(2)) where:

- The person carries on a business that includes holding or dealing in financial arrangements that are the same or similar; and
- The person is not associated with the person owing the amount written off.

Bad debts–agreements for sale and purchase of property or services

Section EH 54(4) allows a person a bad debt deduction (for an amount that is not allowed as a deduction under section EH 54(2) or (3)) where:

- The financial arrangement is an agreement for the sale and purchase of property or services; and
- The person carries on a business of dealing in the property or services that are the subject of the agreement.

Previous rules applying to trade credits have been integrated with the rules for agreements for the sale and purchase of property, and these have also been extended to apply to the provision of services. As a result of the integration, the bad debt provisions are extended to taxpayers in the business of dealing in the goods or services that are the subject of the agreements for the sale and purchase of property or services.

Transitional adjustments

As mentioned earlier, the amended accrual rules (Division 2) apply to financial arrangements entered into on or after 20 May 1999. However, under section EH 17 taxpayers are able to elect to apply these new rules to financial arrangements entered into before that date (ie Division 1 financial arrangements). This will be useful if taxpayers wish to account for all arrangements on a similar basis. Further details of this option, and other changes to the accruals rules, are included in the full discussion on the amending legislation in *TIB* Vol 11, No 6 (July 1999).

Income Tax Act 2004

The Ruling is not in respect of the Income Tax Act 2004. However, section YA 3(3) of the Income Tax Act 2004 provides that the provisions of this Act are the provisions of the Income Tax Act 1994 in rewritten form, and are intended to have the same effect as the corresponding provisions of the Income Tax Act 1994 except in the case of a new law specified in Schedule 22A (identified policy changes). Section YA 3 provides:

> **YA 3 Transitional provisions—**
>
> Reference to this Act can include earlier Act
>
> (1) A reference in an enactment or document to this Act, or to a provision of it, is to be interpreted as a reference to the Income Tax Act 1994 (or to the Income Tax Act 1976), or to the corresponding provision of the earlier Act, to the extent necessary to reflect sensibly the intent of the enactment or document.
>
> *Reference to earlier Act can include this Act*
>
> (2) A reference in an enactment or document to the Income Tax Act 1994 (or to the Income Tax Act 1976),

or to a provision of that earlier Act, is to be interpreted as a reference to this Act, or to the corresponding provision in this Act, to the extent necessary to reflect sensibly the intent of the enactment or document.

Intention of new law

(3) Except when subsection (5) applies, the provisions of this Act are the provisions of the Income Tax Act 1994 in rewritten form, and are intended to have the same effect as the corresponding provisions of the Income Tax Act 1994.

Old law is interpretation guide

(4) Except when subsection (5) applies, in circumstances where the meaning of a taxation law that comes into force at the commencement of this Act (new law) is unclear or gives rise to absurdity,—

(a) the wording of a taxation law that is repealed by section YA 1 and that corresponds to the new law (old law) must be used to determine the correct meaning of the new law; and

(b) it can be assumed that a corresponding old law provision exists for each new law provision.

Limits to subsections (3) and (4)

(5) Subsections (3) and (4) do not apply in the case of—

(a) a new law specified in schedule 22A (Identified policy changes); or

(b) a new law that is amended after the commencement of this Act, with effect from the date on which the amendment comes into force.

Section DB 23(1)(a) in the Income Tax Act 2004 corresponds with section DJ 1(a)(iii) and provides for the same legal tests in that a debt must be both bad and written off in the income year for a deduction to be allowed. The requirements in section DB 23(1) are referred to in section EZ 37 (which concerns accrued income written off) and correspond with section EH 6 of the Income Tax Act 1994. Sections DB 23 and EZ 37 of the Income Tax Act 2004 provide:

Bad debts

DB 23 Bad debts

DB 23(1) No deduction (with exception)
A person is denied a deduction in an income year for a bad debt, except to the extent to which—
(a) the debt is written off as bad in the income year; and
(b) in the case of the bad debts described in subsections (2) to (5), the requirements of the relevant subsection are satisfied.

DB 23(2) Deduction: financial arrangement debt: amount of income
A person who derives assessable income from a financial arrangement to which the financial arrangements rules apply is allowed a deduction for an amount owing under the financial arrangement, but only to the extent to which—
(a) the amount is a bad debt and subsection (1)(a) is satisfied; and
(b) the amount is attributable to the income; and
(c) subsection (5) does not limit the deduction.

DB 23(3) Deduction: financial arrangement debt: dealers in arrangements
A person is allowed a deduction for an amount owing under a financial arrangement to which the financial arrangements rules apply, but only to the extent to which—
(a) the amount is a bad debt and subsection (1)(a) is satisfied; and
(b) the person carries on a business for the purpose of deriving assessable income that includes dealing in or holding financial arrangements that are the same as, or similar to, the financial arrangement; and
c) the person is not associated with the person owing the amount written off; and
(d) subsection (5) does not limit the deduction.

DB 23(4) Deduction: financial arrangement debt: dealers in property or services sold
A person is allowed a deduction for an amount owing under a financial arrangement to which the financial arrangements rules apply, but only to the extent to which—
(a) the amount is a bad debt and subsection (1)(a) is satisfied; and
(b) the financial arrangement is an agreement for the sale and purchase of property or services; and
(c) the person carries on a business of dealing in the property or services that are the subject of the agreement; and
(d) the person carries on the business for the purpose of deriving assessable in come; and
(e) subsection (5) does not limit the deduction.

DB 23(5) Deduction: bad debt representing loss already offset
A person is allowed a deduction for a bad debt only to the extent to which it is more than the total of the amounts offset under section IG 2 (Net loss offset between group companies) that are described in paragraphs (e) and (f) if—
(a) the person writing off the amount of debt is a company (company A); and
(b) the debt is owed to it by another company (company B); and
(c) company B—
  (i) itself uses the amount giving rise to the debt; or
  (ii) uses it to fund directly or indirectly another company (company C) that uses the amount; and
(d) company B or company C has a net loss, in the calculation of which the amount used is taken into account; and
(e) company A, or a company that is in the same group of companies as company A at any time in the income year in which company B or company C has the net loss, offsets an amount for the net loss under section IG 2 (Net loss offset between group companies); and
(f) the offset is in a tax year before the tax year that corresponds to the income year in which company A writes off the amount of debt (but not before the 1993–94 tax year).

DB 23(6) Link with subpart DA
The link between this section and subpart DA (General rules) is as follows:

(a) subsection (1) overrides the general permission; and
(b) for subsections (2) to (5),—
  (i) they supplement the general permission, to the extent to which they allow a deduction that is denied under the general permission; and
  (ii) they override the general permission, to the extent to which they deny a deduction that is allowed under the general permission; an
  (iii) the other general limitations still apply.

Defined in this Act: agreement for the sale and purchase of property or services, amount, assessable income, associated person, business, company, deduction, financial arrangement, financial arrangements rules, general limitation, general permission, group of companies, income year, net loss, supplement, tax year

EZ 37 Accrued income written off

EZ 37(1) [Deduction for bad debt — general]
A deduction is allowed to a person for an amount written off by the person as a bad debt in respect of a financial arrangement where and to the extent that—
(a) the person derives income in respect of the financial arrangement under any of sections EZ 32, EZ 34(4), EZ 35, and EZ 39; and
(b) the amount written off is attributable to that income.

EZ 37(2) [Deduction for bad debt — dealers]
A deduction is allowed to a person for an amount written off by the person as a bad debt in respect of a financial arrangement (not being an amount allowed as a deduction under subsection (1)) where—
(a) the person—
  (i) carries on a business which comprises holding or dealing in such financial arrangements; and
  (ii) is not associated with the person owing the amount written off; or(b)the financial arrangement is a trade credit and the person carries on a business of dealing in the goods or services for which the trade credit is a debt.

EZ 37(3) [Deduction for security payment]
Where a person receives a security payment in relation to a loss and a deduction is denied to the person for the loss other than under this subsection, the person is allowed a deduction for the loss no greater than the amount of the security payment.

EZ 37(4) [Requirements for bad debt deduction]
A deduction for bad debts is allowed under this section only where the requirements of section DB 23(1) and (5) have been met.

EZ 37(5) [Requirements for share loss deduction]
A deduction for a share loss (within the meaning of section DB 18) is allowed under subsection (3) only where the requirements of section DB 18 have been met.

Section EZ 37 of the Income Tax Act 2004 is identical word for word with section EH 6 of the Income Tax Act 1994, other than in respect of section cross-references where the section numbers have changed. The new section DB 23 is an amalgam of sections DJ 1(a)(i), (iii), (iv) and EH 54—there are some wording and layout changes, but it does not appear that the law has changed. The Ruling applies in respect of section DJ 1(a)(iii) of the Income Tax Act 1994 which sets out one of the requirements to be satisfied for a bad debt deduction to be allowed: that “the debt is actually written off as a bad debt by the taxpayer in the income year”. In the Income Tax Act 2004 section DB 23(1)(a) states the requirement in the following terms: that “the debt is written off as bad in the income year”. While the word “actually” is not included in the rewritten provision, the two provisions provide for the same legal tests that a debt must be both bad and written off in the income year for a deduction to be allowed. The conclusion that these are corresponding provisions is confirmed as sections DB 23 and EZ 37 are not listed in schedule 22A of the Income Tax Act 2004 which sets out any identified policy changes in the new Act. While this commentary is concerned with the deductibility of bad debts for the creditor, not remission income of the debtor, it is noted, however, that there has been a change implemented in section CG 2(3) of the Income Tax Act 2004 such that an amount that is remitted is treated as income in the year it is recovered, rather than in the year the deduction was allowed.

Saving of binding rulings

The new Income Tax Act 2004 states in section YA 4 that certain binding rulings issued in relation to the Income Tax Act 1994 are preserved and continued. This applies where a binding public ruling is issued before 1 April 2005 in relation to a provision in the Income Tax Act 1994 (old law) that corresponds to the Income Tax Act 2004 (new law). The binding ruling about the old law is treated as if it were made about the corresponding provision in the Income Tax Act 2004. In such circumstances where the application of the binding ruling is continued, a binding ruling on how the new law applies cannot be made. Section YA 4 provides:

YA 4 Saving of binding rulings

YA 4(1) When, and extent to which, this section applies
This section applies when, and to the extent to which,—
(a) either—
  (i) an applicant has applied for a private ruling, a product ruling, or a status ruling before 1 April 2005 on an arrangement that is entered into, or that the applicant seriously contemplates will be entered into, before the commencement of this Act; or
  (ii) a public ruling is issued before 1 April 2005; and
(b) the binding ruling is about a taxation law that is repealed by section YA 1 (old law); and
(c) a new taxation law that corresponds to the old law (new law) comes into force at the commencement of this Act; and
(d) if this section did not exist, the commencement of this Act would mean that the binding ruling would cease to apply because of section 91G of the Tax Administration Act 1994.

YA 4(2) Ruling about new law
The binding ruling is treated as if it were made about the new law, so that the effect of the ruling at the commencement of this Act is the same as its effect before the commencement.

YA 4(3) No confirmation rulings
To the extent to which a binding ruling continued by subsection (2) applies to an arrangement, or to a person and an arrangement, the Commissioner must not make a binding ruling on how—

(a) the new law applies to the arrangement or to the person and the arrangement; or

(b) this subsection applies to the arrangement or to the person and the arrangement.

Therefore, because it is considered that sections DJ 1(a)(iii) and EH 6 in the Income Tax Act 1994 are corresponding provisions to sections DB 23(1)(a) and EZ 37 in the Income Tax Act 2004, the Ruling and the reasoning in this commentary which relate to section DJ 1(a)(iii) in the Income Tax Act 1994 will be deemed to also relate to section DB 23(1)(a) in the Income Tax Act 2004 from the date the 2004 Act comes into force.

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, Court of Appeal, Privy Council and the Supreme Court.

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.

TAXPAYER WINS FILM INVESTMENT CASES

Case:	Peterson v CIR
Decision date:	28th February 2005
Act:	Income Tax Act 1976
Keywords:	tax avoidance, film investment, depreciation.

Summary

The taxpayer was successful before the Privy Council in arguing that the Commissioner could not apply the anti-avoidance provisions to his investment in two film projects (the investments being made in the 1980s).

Facts

These were cases taken by the taxpayer in relation to two film investments made in the 1980s. The films were "Lie of the Land" and "Utu". In both cases the Commissioner concluded that the expenses of the films were inflated by means of non-recourse loans and circular funding. This increased the depreciation deduction apparently available to the taxpayer but for which there was no actual liability as the circular funding at already repaid the loans. The Commissioner disallowed the depreciation deduction to the extent of the inflated expenses.

The taxpayer objected and the cases were heard at the TRA. The taxpayer won one and the Commissioner the other. Both TRA decisions were appealed to the High Court where the taxpayer won one again and the Commissioner the other (see (2002) 20 NZTC 17,583 and 17,761). Both decisions were appealed to the Court of Appeal where the Commissioner won both ((2003) 21 NZTC 18,060 and 18,069).

The taxpayer appealed to the Privy Council.

The main issue was the proper application of section 99 ITA 1976 to the taxpayer. The taxpayer argued that there was no tax avoidance by him and as he was not part of the "meeting of minds" necessary for an arrangement under section 99 (the test from *BNZI* [2002] 1 NZLR 450) then section 99 could not be applied to him. Further, it was argued that the taxpayer entered a fixed-price contract and this was the cost to him of the investment regardless of what consequently occurred outside his knowledge.

The Commissioner argued that section 99 could be applied to the taxpayer as there was a tax avoidance arrangement which also met the *BNZI* test even though the taxpayer was not one of those involved in the necessary "meeting of minds" and he was a "person affected by that arrangement" (per section 99(3). The Commissioner also placed weight upon the phrase "whether or not any person affected by that arrangement is a party thereto" (at section 99(2)).

Decision

In a split decision the taxpayer was successful (split 3–2 in the taxpayer's favour).

Majority decision

The majority accepted the existence of an "arrangement" in this case and considered it was entirely at the CIR's option to identify the whole or any part of a composite scheme as the "arrangement".

The majority did not accept the taxpayer's argument that he needed to be a party or participant to an arrangement to be effected by it:

> [34] Their Lordships are satisfied that the "arrangement" which the Commissioner has identified had the purpose or effect of reducing the investors' liability to tax and that, whether or not they were parties to the arrangement or the relevant part or parts of it, they were affected by it. Their Lordships do not consider that the "arrangement" requires a consensus or meeting of minds; the taxpayer need not be a party to "the arrangement" and in their view he need not be privy to its details either. On this point they respectfully prefer the dissenting judgment of Thomas J. in Commissioner of Inland Revenue v BNZ Investments Ltd (supra). Moreover the investors did not merely obtain an economic advantage from the "arrangement" (as in that case); they obtained a tax advantage, viz. a depreciation allowance which reduced their liability to pay tax.

This approach was expressly endorsed by the minority judgment as well (at par [93]).

However, the "critical question" identified by the majority was whether the tax advantage was obtained by tax avoidance and thus within sec 99 (now sec BG1).

The majority considered that the taxpayers are entitled to depreciate the full acquisition costs regardless of how much the film actually cost to make as the CIR did not challenge the apparent acquisition cost of actual cost of the film plus the non-recourse lending. The focus is on the cost to the person acquiring the asset rather than the person disposing of it and what they did with the purchase price (in this case repay the non recourse lending but not discharge the investors apparent liability under the loan):

[42]….If the Commissioner had shown that the features on which he relied, singly or in combination, had the effect that the investors, while purporting to incur a liability to pay $x+y to acquire the film, had not suffered the economic burden of such expenditure before tax which Parliament intended to qualify them for a depreciation allowance, then he could invoke section 99 to disallow the deduction.

[43] This, however, the Commissioner never succeeded in doing. The inflation of the costs of making the film meant that the production company made a secret profit at the investors' expense; but it did not alter the fact that they incurred a liability to pay $x+y to the production company in accordance with the contract to acquire the film. The costs of making the film were incurred by the production company, and these must not be confused with the costs incurred by the investors, which were the relevant costs in respect of which the deduction was claimed. The fact that the production company made a profit of $y at the expense of the investors did not mean that they did not suffer the economic cost of paying it.

The majority then pointed to a factor that may have enabled the Commissioner to be successful: if there had been a finding of fact at the TRA that the lending was un-commercial [Para 48]. It was also suggested that had the CIR argued that to the extent of the non-recourse lending was repaid by the production company, the taxpayer did not purchase a film but paid for the acquisition of a loan. This would not have been deductible as part of the cost of acquiring a film [Para 49 to 51].

The minority

The minority considered that this was a tax avoidance arrangement.

While accepting the "meeting of minds" test found in BNZI the minority recognised:

> [59]… But, nonetheless, it is clear from sub-section (2) that the tax advantage vulnerable to being nullified under sub-section (3) may be a tax advantage enjoyed by someone who is not part of that consensus, not "… a party thereto".

> [89]… sub-section (2) says, in terms, that the arrangement "shall be absolutely void as against the Commissioner … whether or not any person affected by the arrangement is a party thereto". The fact that the investors were not parties to the arrangement cannot be enough to allow them to escape section 99. Any other conclusion would involve a judicial rewriting of section 99(2).

> [92]… To hold that the apparent ignorance of the investors excuses them from vulnerability to the statutory avoidance measures provided by section 99 would be, in our opinion, to emasculate the section.

The minority focused on (and endorsed) the twin pillars of statutory interpretation: statutory scheme and purpose (as found in the Challenge case). Applying the scheme and purpose approach to the facts of the case the minority concluded:

> [91]…The statutory right to depreciate an item of cost and to deduct the amount of the depreciation from assessable income is plainly a tax advantage. Whether it is a tax advantage vulnerable to attack under section 99 depends, in our opinion, on whether it is within the purpose of the statutory regime. We cannot believe that if the cost of acquisition of a film is inflated for no commercial reason other than that of qualifying for a higher tax deduction than would otherwise be available the amount of the inflation could be regarded as the sort of cost that the statutory regime was intended to assist or encourage. In any event, in the present case the amount of each non-recourse loan was not presented to the investors as a premium on the cost of production that they had to pay. It was presented to them on the basis that the amount was needed for the cost of production and that it would qualify for depreciation as part of the cost of production. The non-recourse loan was, in fact, nothing of the sort but was no more than a device to produce a higher capital sum to be depreciated and, thereby, a higher tax deduction. Moreover the amounts represented by the non-recourse loans were not received by the respective production companies as premiums that had to be paid as part of the investors' acquisition costs. They were not recorded in their books as having been received at all.

WARRANTY PAYMENTS PAID BY OVERSEAS MANUFACTURERS OF MOTOR VEHICLES TO IMPORTERS NOT EXEMPT FROM GST

Case: CIR v Motorcorp Holdings Ltd & Ors

Decision date: 7 March 2005

Act: Goods and Services Tax Act 1986

Keywords: warranty payments, overseas manufacturers, contracts of insurance, supply, repair services, GST

Summary

Warranty payments paid by overseas manufacturers of motor vehicles to importers to reimburse them for amounts paid to dealers for repair services on faulty motor vehicles before 1 August 2002 are not exempt from GST as contracts of insurance within section 5(13) of the GST Act.

Facts

The appeal and cross-appeals concerned the imposition of GST on certain warranty payments in relation to imported cars. All respondents ("the car companies") purchase cars for import into New Zealand from overseas manufacturers. The car companies receive warranties from the manufacturers. The car companies on sell the cars to dealers, and in turn provide their own warranties to the retail purchasers. When repairs are carried out on the cars under the warranty provided by the car companies, the dealers claim the cost from the car companies, who in turn claim either the full cost, or a portion of it, from the overseas manufacturers pursuant to the warranty from the manufacturer.

The subject matter of these proceedings was whether GST applies to payments received by the car companies from the overseas manufacturers pursuant to such warranties, prior to a legislative change exempting payments from 1 August 2002.

Decision

Venning J found in favour of the car companies. He concluded the arrangements between the car companies and their manufacturers did amount to insurance contracts. He noted the car companies took on the obligation of the manufacturers to meet the manufacturer's warranty in New Zealand, and the arrangement had other features similar to an insurance contract. For instance the cars would not necessarily need repairing, so it was not certain any claim would be made. The Commissioner appealed.

Decision under appeal

The Court of Appeal (McGrath Hammond and William Young JJ) allowed the Commissioner's appeal, for differing reasons. William Young J considered that section 5(13) was a red herring, as both sides agreed the subsection does not literally apply. His Honour considered the key question was whether there was a supply for the purposes of section 5(1), and rested his decision on a finding there was a supply of repair s ervices, even though this issue had not been raised at first instance, rather than on whether or not the transactions were contracts of insurance within section 5(13).

McGrath and Hammond JJ found that the contracts before the Court were not contracts of insurance. Their Honours considered it is of great significance that the transactions are expressed to be "warranty" transactions, and that they operated as warranty claims, and not in line with procedures used in insurance claims. The court accepted that at a general level there was "indemnification" but noted that features one would expect to see in an insurance contract were distinctly absent. For instance, no policy was issued, and no premium was distinctly identified. No fund was created to meet future claims. There was no transfer of risk.

All members of the court dismissed the taxpayer's cross appeals. It was accepted the High Court had correctly found there was no contractual justification for the contention that the warranty payments were a refund of part of the purchase price paid for the motor vehicles.

QUESTION 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.

HHG PLC CAPITAL REDUCTION PROPOSALS – TAX IMPLICATIONS FOR NEW ZEALAND SHAREHOLDERS

Introduction

1. This statement is issued to alert investors in HHG plc ("HHG") to the New Zealand dividend consequences of the proposed capital reduction by HHG which is expected to occur in April 2005.
2. HHG was demerged from AMP Limited and separately listed in December 2003. Many New Zealand taxpayers now hold interests in HHG known as CHESS depository interests ("CDIs"), each interest representing one HHG Ordinary Share. The Commissioner considers each CDI holder to be a shareholder in HHG for New Zealand income tax purposes.
3. HHG has announced a proposal to sell its Life Services business to Life Company Investor Group Limited for a cash consideration of approximately £1 billion. HHG will be renamed Henderson Group plc when the sale has been completed. Following the sale, HHG proposes to return approximately £875 million of the cash proceeds to shareholders through two main steps set out in the HHG Shareholder Circular known as the Return of Cash and the Reduction of Investor Base proposals.

Return of Cash proposal

4. Under the Return of Cash proposal, all CDI holders (effectively shareholders) will receive cash in exchange for the cancellation of their CDIs in a ratio of 52 of every 100 CDIs held on the Record Date, which is currently expected to be 15 April 2005. For instance, a taxpayer with 1,040 CDIs will have 541 CDIs cancelled in the Return of Cash proposal, which will leave 499 CDIs. For New Zealand CDI holders, the cash amount paid by HHG in respect of the cancellation will be calculated as the NZ$ equivalent of 55 pence per CDI cancelled.

Reduction of Investor Base proposal

5. Under the Reduction of Investor Base proposal, unless the investor elects otherwise, HHG will cancel a further number of CDIs determined by reference to a "fractional entitlement" calculation performed for each CDI holder. This cancellation is designed to reduce the number of smaller shareholders (including CDI holders) in HHG.
6. CDI holders with fewer than 1,041 CDIs on the Record Date (ie, fewer than 500 CDIs after the Return of Cash proposal takes effect, which is expected to be on 15 April 2005) will have their entire remaining holding of CDIs cancelled in exchange for cash unless they elect otherwise. The final date for returning the Election Form is 15 April 2005.
7. Holders of a greater amount than 1,041 CDIs, unless they elect otherwise, will also have a certain amount of CDIs cancelled, up to a maximum of 499 CDIs per holder so that they will have an even multiple of 500 CDIs remaining. Those who hold an even multiple of 500 CDIs after the Return of Cash proposal will not have any CDIs cancelled.
8. The consideration for each CDI cancelled under this proposal will be determined by the average closing price for HHG's shares traded on the London Stock Exchange over the 20 business days immediately before the Record Date, plus a premium of 5% of the average price. Each CDI cancelled as a result of the proposal will receive the NZ$ equivalent of this amount determined by reference to a defined Exchange Rate.

Analysis

9. This statement is intended to clarify the New Zealand dividend consequences for CDI holders of HHG in relation to the capital reduction proposals by HHG. The outcomes below apply only to New Zealand resident CDI holders that hold their CDIs on capital account.
10. On the basis of the information provided by HHG, including the HHG Shareholder Circular, and on certain specific assumptions advised to HHG, the Commissioner has concluded the following about the Return of Cash and the Reduction of Investor Base proposals. Unless otherwise stated, all statutory references are to the Income Tax Act 2004.

The Return of Cash proposal

Will any part of the cancellation amount payable to CDI holders be a dividend in respect of those holders for New Zealand tax purposes?

11. The cancellation amount in respect of the Return of Cash proposal will be excluded from being a dividend under section CD 3 for New Zealand tax purposes, by virtue of section CD 14.

The Reduction of Investor Base proposal

Will any part of the cancellation amount payable to CDI holders be a dividend in respect of those holders for New Zealand tax purposes?

12. For CDI holders whose holdings are reduced by 15% or more under the Reduction of Investor Base proposal as a result of the cancellation, the Commissioner is satisfied that the cancellation amount to be paid in respect of that proposal will be excluded from being a dividend under section CD 3 for New Zealand tax purposes by virtue of section CD 14.

13. For instance, a person who held 1,400 CDIs after the Return of Cash proposal, resulting in 400 CDIs being cancelled under the Reduction of Investor Base proposal, will not receive a dividend, because the cancelled CDIs represent more than 15% of their CDIs remaining after the Return of Cash cancellation.

14. For CDI holders whose cancelled CDIs represents less than 15% of their CDIs remaining after the Return of Cash cancellation, the payment will constitute dividend income for the relevant New Zealand CDI holder. For non-corporate CDI holders this income will be subject to income tax at marginal tax rates on a normal assessment basis. This is likely to affect most investors with greater than about 6,000 CDIs at the Record Date, but will also affect a number with a smaller holding.

Examples – the Reduction of Investor Base proposal

Cancellation proceeds that *are not* income

15. Prudence is a New Zealand CDI holder with a total of 1,040 CDIs in HHG. She has decided not to opt out of the Reduction of Investor Base proposal. The number of CDIs held by Prudence after the Return of Cash proposal takes effect will be 499. The CDIs cancelled under the Reduction of Investor Base proposal will therefore be all of the remaining 499 CDIs. Prudence has asked Inland Revenue to clarify her New Zealand tax liabilities for the cash payment received from HHG.

16. The 499 CDIs cancelled as part of the Reduction of Investor Base proposal represent 100% of her CDIs prior to that cancellation. Therefore, no part of the payment received from HHG will constitute dividends (whether the amount is then taxable as a business gain depends on whether the shares were held on revenue account).

Cancellation proceeds that *are* income

17. Alexander is a New Zealand CDI holder in HHG, having a total of 10,000 CDIs. He has decided not to opt out of the Reduction of Investor Base proposal. The number of CDIs held by Alexander after the Return of Cash proposal takes effect will be 4,800. The CDIs cancelled under the Reduction of Investor Base proposal will be 300 CDIs, reducing Alexander's remaining holding to 4,500 (an even multiple of 500). Alexander has asked Inland Revenue to clarify his New Zealand tax liabilities for the cash payment received from HHG.

18. The cancellation proceeds received in respect of the Return of Cash proposal will not be a dividend. However, the cancellation proceeds attributable to the 300 CDIs cancelled under the Reduction of Investor Base proposal represents only 6.25% of Alexander's total CDIs remaining after the Return of Cash proposal. Inland Revenue's position is that the cancellation proceeds attributable to the Reduction of Investor Base proposal, therefore, are subject to New Zealand income tax as a dividend.

Conditions and other information

19. These conclusions are contingent on:

    - the two proposals and the related steps being undertaken on the terms set out in the HHG Shareholder Circular and other information provided to Inland Revenue; and
    - certain assumptions, which have been advised by Inland Revenue to HHG, being correct.

20. As these technical requirements cannot be confirmed until the proposals proceed, Inland Revenue expects to publish a follow-up item in the *Tax Information Bulletin* to confirm the conclusions stated above, after that time.

21. This statement does not consider the application of sections CA 1(2), CB 1, CB 3 and CB 4, to particular taxpayers, or the effects of any other aspects of the HHG proposals.

TABLE 1: *Return of Cash proposal for CDI holders*

22. For each CDI cancelled as part of this proposal a CDI holder will receive the New Zealand dollar equivalent of 55 pence per CDI, which is determined by reference to the Exchange Rate. Table 1 provides an illustrative example (similar to that contained in the HHG Shareholder Circular) of the cash received if the Return of Cash proposal takes effect.

Number of CDIs held on the Record Date	Number of CDIs (including fractions) which would otherwise be cancelled	Number of CDIs cancelled in the Return of Cash	Number of CDIs remaining *after* the Return of Cash takes effect	Cash received if the Return of Cash takes effect	
				Shareholders (£)	CDI Holders (NZ$)
100	52.00	52	48	28.60	75.66
245	127.40	127	118	69.85	184.74
1,040	540.80	541	499	297.55	786.98
1,041	541.32	541	500	297.55	786.98
2,100	1,092.00	1,092	1,008	600.60	1,588.75
10,000	5,200.00	5,200	4,800	2,860.00	7,565.46

23. The New Zealand dollar rate in the above example was recorded as at 7 February 2005. The actual New Zealand dollar equivalent of the Return of Cash Price may be higher or lower than the price shown.

TABLE 2: *Reduction of Investor Base proposal for CDI Holders*

24. Table 2 provides an illustrative example (similar to that contained in the HHG Shareholder Circular) of the effect of the Reduction of Investor Base proposal for CDI holders. CDI holders whose “fractional entitlement” calculation results in CDIs being cancelled will be paid a cash amount for each CDI cancelled equal to the New Zealand dollar equivalent of the Reduction of Investor Base Price.

Holding of CDIs on Record Date	Number of CDIs remaining *after* the Return of Cash takes effect	Number of Consolidated Shares which would arise if the CDI Holder held Ordinary Shares rather than CDIs	Cash to be paid in respect of fractions (NZ$)	Number of CDIs held *after* the Reduction of Investor Base takes effect
100	48	0.096	69.93	Nil
245	118	0.236	171.91	Nil
1,040	499	0.998	727.02	Nil
1,041	500	1.000	Nil	500
2,100	1,008	2.016	11.65	1,000
10,000	4,800	9.600	437.02	4,500

25. The Reduction of Investor Base Price in the above example is assumed to be 57 pence per CDI and the New Zealand dollar rate was recorded as at 7 February 2005. The actual Reduction of Investor Base Price and the New Zealand dollar equivalent may be higher or lower.

Summary

26. If you hold CDIs in HHG (generally because you were an AMP shareholder) and do not elect out of the Reduction of Investor Base proposal you will receive cash for the cancellation of all or part of your CDIs under both the Return of Cash and the Reduction of Investor Base proposal (unless you hold an even multiple of 500 CDIs after the Return of Cash proposal has taken effect). In some cases, the cash proceeds attributable to the Reduction of Investor Base proposal will be treated as a taxable dividend. This arises when the cancelled CDIs for the Reduction of Investor Base proposal represent less than 15% of the total number of HHG securities held by you after the initial Return of Cash proposal.

REGULAR FEATURES

DUE DATES REMINDER

April 2005

7 End-of-year income tax

- **7 April 2005**

  2004 end-of-year income tax due for clients of agents with a March balance date

20 Employer deductions

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

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

29 GST return and payment due

May 2005

20 Employer deductions

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

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

31 GST return and payment due

These dates are taken from Inland Revenue's *Smart business tax due date calendars 2004–2005 and 2005–2006*. These calendars reflect the due dates for small employers only—less than $100,0000 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.

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Draft interpretation statement	***Comment deadline***
☐ IS0033: Company deductions	30 April 2005

Draft question we've been asked	***Comment deadline***
☐ QB0030: Commissioner's power to issue a replacement ruling that operates retrospectively	30 April 2005

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