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TAX INFORMATION *Bulletin*

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Inland Revenue
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YOUR OPPORTUNITY TO COMMENT

Inland Revenue regularly 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 a user of that legislation, is highly valued.

A list of the items we are currently inviting submissions on can be found at **www.ird.govt.nz**. On the homepage, click on "Public consultation" in the right-hand navigation. Here you will find drafts we are currently consulting on as well as a list of expired items. You can email your submissions to us at **public.consultation@ird.govt.nz** or post them to:

Public Consultation
Office of the Chief Tax Counsel
Inland Revenue
PO Box 2198
Wellington 6140

You can also subscribe to receive regular email updates when we publish new draft items for comment.

IN SUMMARY

Binding rulings

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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 their tax liability based on it.

For full details of how binding rulings work, see *Binding rulings: How to get certainty on the tax position of your transaction (IR 715)*. You can download this publication free from our website at **www.ird.govt.nz**

PUBLIC RULING BR PUB 14/07: DEDUCTIBILITY– INTEREST REPAYMENTS REQUIRED AS A RESULT OF THE EARLY REPAYMENT OF A FINANCIAL ARRANGEMENT

This is a reissue of BR Pub 10/21. For more information about the history of this Public Ruling see the Commentary to this Ruling.

Taxation Laws

All legislative references are to the Income Tax Act 2007 unless otherwise stated.

This Ruling applies in respect of ss DA 1, DB 6, DB 7, DB 11 and EW 31.

The Arrangement to which this Ruling applies

The Arrangement is as follows:

- A person places an amount of money on term deposit.
- The term deposit is a financial arrangement subject to the financial arrangements rules.
- The term deposit contract provides that the rate of interest payable will be reduced in the event of the withdrawal, in part or in full, of the principal sum before the contractual maturity date.
- The depositor withdraws the whole or part of the term deposit before the contractual maturity date.
- The application of the reduced rate of interest requires the repayment of interest already derived by the depositor or the set-off of interest owed against the principal sum ultimately repaid to the depositor.

How the Taxation Laws apply to the Arrangement

The Taxation Laws apply to the Arrangement as follows.

Full withdrawal of the term deposit

Where the depositor withdraws the full amount of the term deposit before the contractual maturity date the following applies:

- A base price adjustment is required.
- The amount of repaid interest is included in the “consideration” element of the base price adjustment.
- If the base price adjustment gives rise to a negative amount, that amount is expenditure incurred under the financial arrangements rules.
- Expenditure incurred under the financial arrangements rules is deemed to be interest.
- A deduction may be available under s DB 6 (Interest: not capital expenditure) or s DB 7 (Interest: most companies need no nexus with income).
- If a deduction is not available under ss DB 6 or DB 7, a deduction is allowed under s DB 11 to the extent the amount arises from assessable income derived by the person under the financial arrangement in earlier income years.

Partial withdrawal of the term deposit

Where the depositor withdraws part of the amount of the term deposit before the contractual maturity date the following applies:

- A base price adjustment is not required.
- Depositors who are not cash basis persons, and cash basis persons who have elected to adopt a spreading method, must apply *Determination G25: Variations in the Terms of a Financial Arrangement* when the term deposit is varied by the partial withdrawal. The repaid interest is included in the calculation under the determination and an adjustment is made in the year of variation.

Cash basis persons

- Depositors who are cash basis persons who have not elected to adopt a spreading method may deduct the repaid interest at the time it is incurred only if the general permission is satisfied. To satisfy the general permission there must be a sufficient relationship between the repayment of the interest and the earning of assessable income. The Commissioner considers the relationship between the repayment and the interest income earned under the term deposit is insufficient to satisfy s DA 1(1)(a). However, the Commissioner considers that a deduction for the repayment may be available under the general permission if it can be shown that the expenditure was incurred in the course of carrying on a business for the purpose set out in s DA 1(1)(b).

- If the amount of the repaid interest is not deductible at the time of repayment, it falls to be dealt with on maturity of the deposit through the base price adjustment.
- The amount of repaid interest is included in both the "consideration" and "expenditure" elements of the base price adjustment.
- If the base price adjustment gives rise to a positive amount, that amount is income derived. However, it is not income to the extent it arises from expenditure incurred under the financial arrangement in earlier income years and for which a deduction was denied.
- Therefore, a positive base price adjustment amount in the final year of the term deposit will be reduced by the amount of interest repaid in the year of partial withdrawal.

The period or tax year for which this Ruling applies

This Ruling will apply for an indefinite period beginning on 17 December 2013.

This Ruling is signed by me on 30 September 2014.

Susan Price
Director, Public Rulings

COMMENTARY ON PUBLIC RULING BR PUB 14/07

This commentary is not a legally binding statement. The commentary is intended to help readers understand and apply the conclusions reached in Public Ruling BR Pub 14/07 (the Ruling).

Legislative references are to the Income Tax Act 2007 unless otherwise stated. Relevant legislative provisions are reproduced in the Appendix to this commentary.

Summary

1. A depositor who withdraws funds early may have to repay a portion of the interest previously derived under the term deposit. The issue this ruling and commentary deal with is whether and when the repaid amount is deductible.
2. The fact a depositor may have to repay interest if they withdraw a deposit early does not mean interest they receive during the course of the deposit is not derived by the depositor. At the time of receipt or crediting of interest, the depositor has earned that interest and it is theirs to deal with as they wish. The fact a liability to repay some of that interest may arise later, if certain events occur, does not alter the fact derivation has occurred. Therefore, the taxation consequences of the repayment of the interest on the full or partial withdrawal of the term deposit amount must be considered.
3. The full withdrawal of a term deposit amount before the contractual maturity date will trigger a base price adjustment (BPA). Where the depositor is required to repay interest previously derived, the amount of repaid interest will be included in the "consideration" element of the BPA. This will generally give rise to a negative BPA amount. A negative BPA amount is expenditure incurred under the financial arrangements rules. Expenditure incurred under the financial arrangements rules is deemed to be interest under s YA 1. A deduction may be available under s DB 6 (Interest: not capital expenditure) or s DB 7 (Interest: most companies need no nexus with income). If a deduction is not available under ss DB 6 or DB 7, a deduction is allowed under s DB 11 to the extent the amount arises from assessable income derived by the person under the financial arrangement in earlier income years.
4. If a depositor partially withdraws the deposit, there is no maturity of the financial arrangement. Therefore, no BPA is performed. In these circumstances, the deductibility of the repaid interest depends on whether the depositor is a cash basis person.

5. A depositor who is not a cash basis person, or who is a cash basis person who has elected to adopt a spreading method, needs to apply *Determination G25: Variations in the Terms of a Financial Arrangement* when the term deposit is varied by the partial withdrawal. The repaid interest will be brought into the Determination G25 calculation and an adjustment made in the year of variation. A BPA is done when the term deposit finally matures.
6. Where a cash basis person does not adopt a spreading method, expenditure incurred during the term of a financial arrangement will be deductible at the time it is incurred only if the general permission is satisfied. To satisfy the general permission there must be a sufficient relationship between the repayment of the interest and the earning of assessable income. The Commissioner considers the relationship between the repayment and the interest income earned under the term deposit is insufficient to satisfy s DA 1(1)(a). As the amount of the repaid interest is not deductible at the time of repayment, it falls to be dealt with through the BPA on maturity of the deposit. However, the Commissioner considers that, where the expenditure has been incurred in carrying on a business, a deduction may be available under s DA 1(1)(b). Whether the repayment of interest satisfies the nexus test for a business will depend on the facts of each case.
7. The amount of the repaid interest will be included in both the "consideration" and "expenditure" elements of the BPA calculation. The application of the BPA at maturity will generally result in a positive amount, which reflects the receipt of interest income in the final year of the term deposit.
8. A positive BPA amount is income, except to the extent it arises from expenditure incurred under the financial arrangement in earlier income years and for which a deduction was denied. Therefore, the amount of interest income derived in the final year of the term deposit will be reduced by the amount of interest repaid in an earlier year. However, an amount of repaid interest for which a deduction was available will not reduce the amount of interest income derived in the final year of the term deposit. This ensures the depositor returns the correct amount of interest income over the full term of the deposit.

Background

9. BR Pub 14/07 is a reissue of BR Pub 10/21, which expired on 16 December 2013. This Ruling is essentially the same as BR Pub 10/21. However, minor amendments have been made to clarify the order of application of ss DB 6, DB 7 and DB 11, in accordance with an amendment to s EW 31(4).
10. A term deposit contract will often include a clause that early withdrawal of the principal sum, in whole or in part, will result in a reduced rate of interest, calculated from the date of the initial deposit. In some cases, this means a depositor who withdraws funds early may have to repay a portion of the interest previously derived under the term deposit.
11. For example, assume that on 1 October 2015 a person invests $10,000 for 12 months at 7%, interest to be credited to the person's bank account six-monthly. Interest of $350 is paid to the person on 31 March 2016. However, on 1 May 2016 the person decides to withdraw $5,000 from the term deposit.
12. The term deposit contract states that the rate of interest on the $5,000 to be withdrawn is reduced to 5% from the date of deposit, 1 October 2015. Therefore, the amount of interest the person should have received in relation to the $5,000 withdrawn is $146 (seven months interest at 5%). The person has already been credited with $175 of interest on the $5,000. Therefore, the person owes the bank $29.
13. This Ruling considers the tax consequences of the depositor's repayment of the interest to the bank.
14. Note that, in practical terms, it is unlikely the depositor would physically repay the interest previously derived to the bank. The more common scenario would be for the bank to deduct the amount of interest owed to it from the amount of the principal to be repaid by it. For example, in the above example the person would receive $4,971 from the bank on early withdrawal (the $5,000 principal withdrawn less the $29 interest to be repaid). Whether such a set-off occurs or not, the transaction is treated for tax purposes as the repayment of the interest owed by the depositor and the return by the bank of the full amount of the principal withdrawn early.

Application of the Legislation

15. The tax consequences of the Arrangement depend upon whether there is a full or partial withdrawal of the deposit early and whether the depositor repaying the interest is a cash basis person. These scenarios are considered below. However, before turning to these scenarios, the preliminary issue of whether the interest under the term deposit is fully derived when received or is only conditionally derived to the extent of the amount liable to repayment must be considered.

Derivation of interest subject to repayment on early withdrawal

16. It may appear that the fact a depositor may have to repay interest if the deposit is withdrawn early indicates that interest under a term deposit is only conditionally derived. However, the Commissioner's view is that interest under a term deposit is fully derived at the time of receipt or crediting. At the time of receipt or crediting of interest, the depositor has earned that interest and it is theirs to deal with as they wish. The fact a liability to repay some of that interest may arise later, if certain events occur, does not alter the fact derivation has occurred.

17. *Bowcock v CIR* (1981) 5 NZTC 61,062 (HC) supports this conclusion. Mr Bowcock was an employee who went on study leave but continued to receive his full salary. The terms of the employment bond provided that if he left his employment within four years of the end of his study leave, he would have to repay some of the amount he had received. He did leave within that time, so was required to repay salary for two income years. He tried to deduct these sums from his income tax returns for the two years. In the High Court, Mr Bowcock claimed he had never derived the amounts because they were contingent receipts not absolute receipts.

18. Vautier J rejected Mr Bowcock's argument. He said at 61,069:

> Upon a consideration of the terms of the bond and the course pursued in this case, I am quite unable to come to the conclusion that the moneys which were paid to the objector during the two years in question can be said to have been received by him conditionally in the sense referred to in the judgments in the High Court in [*Arthur Murray (NSW) Pty Ltd v FCT* (1965) 114 CLR 314 (HCA)]. Those moneys clearly in my view became the absolute property of the objector when they were paid. No conditions or stipulations were attached to those payments themselves. They were clearly received and accepted as of right. Whether or not any liability arose in the future to repay any part of those moneys depended entirely on the course which the objector chose to take.

19. The *Bowcock* principle supports the view that if a taxpayer is liable to repay an amount previously received (for example, for breaching a bond or for the early withdrawal of funds), the repayment of the amount does not change the nature of the original derivation of the funds from absolute to conditional.

20. Vautier J distinguished the decision in *Arthur Murray (NSW) Pty Ltd v FCT* (1965) 114 CLR 314 (HCA) in *Bowcock*. *Arthur Murray* concerned whether income had been derived in the first instance, not the situation where income has been derived but may have to be repaid. It is the latter situation that was covered in *Bowcock*, where the court found that the possibility of repayment did not affect the derivation of the income. The Commissioner's view is that the principles considered in *Bowcock* apply generally, and are not limited to employment situations.

21. In the present arrangement, the depositor has an absolute entitlement to the interest under the term deposit at the time it is received. If the depositor later chooses to withdraw funds before the contracted maturity date, the fact an obligation to repay some of the interest received may arise does not affect that entitlement. The interest has been derived and the nature of the derivation of the funds is not changed from absolute to conditional as a result of the repayment. In addition, in this situation, the contingency arises from a choice of the investor, not as a result of factors outside the investor's control.

22. As the interest income is absolutely derived by the depositor, the taxation consequences of the repayment of interest on the full or partial withdrawal of the term deposit amount must now be considered.

Full withdrawal of the term deposit amount

23. A term deposit is a financial arrangement under s EW 3. Therefore, the financial arrangements rules apply. When a term deposit is withdrawn in full, the financial arrangement has matured and a BPA is required under s EW 29.

24. Although many depositors are likely to be cash basis persons under the financial arrangements rules and not required to use a spreading method, they are still subject to the financial arrangements rules and must do a BPA if they withdraw the term deposit in full.

25. The formula for calculating a BPA is in s EW 31(5). The formula is:

    consideration − income + expenditure
    + amount remitted

    where:

    consideration is all consideration that has been paid, and all consideration that is or will be payable, to the person for or under the financial arrangement, minus all consideration that has been paid, and all consideration that is or will be payable, by the person for or under the financial arrangement. Non-contingent and non-integral fees are ignored;

    income is income derived by the person under the financial arrangement in earlier income years;

expenditure is expenditure incurred by the person under the financial arrangement in earlier income years;

amount remitted is an amount that is not included in the consideration paid or payable to the person because it has been remitted by the person or by law.

26. Where a depositor withdraws a term deposit in full before the contracted maturity date and the depositor is required to repay interest derived in a previous income year, the repaid interest will be included in the "consideration" element of the BPA. The result of the BPA calculation will depend on matters such as the time of receipt of the interest payments, the differential in interest rates and the time of the withdrawal of the term deposit amount.

27. Where the BPA calculation gives rise to a negative amount, s EW 31(4) provides that a negative BPA amount is expenditure incurred by a person in the year the calculation is made. Expenditure incurred under the financial arrangements rules is deemed to be interest.

28. A deduction may be available under s DB 6 (Interest: not capital expenditure) or s DB 7 (Interest: most companies need no nexus with income). Section DB 6 overrides the capital limitation and allows a deduction for interest where the general permission is satisfied. Where the requirements of s DB 7 are satisfied, a company is allowed a deduction for interest expenditure incurred whether or not the expenditure satisfies the general permission. Section DB 7 also overrides the capital limitation, the exempt income limitation and the withholding tax limitation.

29. Where a deduction is not allowed under ss DB 6 or DB 7, a deduction is allowed for the negative BPA amount under s DB 11 to the extent the amount arises from assessable income derived by the person under the financial arrangement in earlier income years. Section DB 11 supplements the general permission and overrides all the general limitations.

30. Where the BPA calculation gives rise to a positive amount, s EW 31(3) provides that the amount is income derived by the person. A positive BPA amount may occur where the depositor derives interest income in the same year as the year in which the withdrawal and repayment of interest occurs. In these circumstances, the BPA calculation ensures that the positive BPA amount is reduced by the amount of the repaid interest.

Examples 1 and 2

Examples 1 and 2 illustrate the above points.

Example 1

On 1 October 2015 Mary (a cash basis person not carrying on a business) invests $10,000 for 12 months at 7%, with interest to be credited to her bank account six-monthly. Interest of $350 is paid to Mary on 31 March 2016. However, on 1 May 2016 Mary decides to withdraw the full amount of the term deposit.

On the early withdrawal of the $10,000, the term deposit contract states that the rate of interest is reduced to 5% from the date of deposit, 1 October 2015. Therefore, the amount of interest Mary should have received for the term deposit is $292 (seven months interest at 5%). As Mary has already been credited with $350 interest (for the first six months), she owes the bank $58. The bank sets off the amount of interest owed against the amount of the principal to be repaid and Mary receives $9,942.

Mary will have to apply the BPA formula to the term deposit in the 2017 income year as follows:

consideration − income + expenditure
+ amount remitted

The consideration Mary received is the repayment of the principal amount of $10,000 and the interest received of $350. The consideration Mary paid is the original deposit of $10,000 and the repayment of interest of $58.

The amount of income Mary derived in earlier income years is $350.

There is no expenditure from earlier years.

No amount is remitted.

Therefore, the BPA is:

($10,350 − $10,058) − $350 + $0 + $0
= $292 − $350
= −$58

The negative BPA amount is expenditure incurred under the financial arrangements rules. Mary has derived income under the financial arrangement in previous income years ($350) and therefore the negative BPA amount of −$58 will be deductible to Mary under s DB 11 in the income year ending 31 March 2017.

Example 2

On 1 November 2015 Sally invests $10,000 for two years at 7%, with interest to be credited to her bank account six-monthly. Interest of $350 is paid to Sally on 30 April 2016, 30 October 2016 and 30 April 2017. However, on 30 June 2017 Sally decides to withdraw the full amount of the term deposit. Sally has a standard balance date.

On the early withdrawal of the $10,000, the term deposit contract states that the rate of interest is reduced to 5% from the date of deposit, 1 November 2015. Therefore,

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the amount of interest Sally should have received for the term deposit is $833 (20 months interest at 5%). Sally has already been credited with $1,050 interest, so she owes the bank $217. The bank sets off the amount of interest owed against the amount of the principal to be repaid and Sally receives $9,783.

Sally will have to apply the BPA formula to the term deposit in the 2018 income year as follows:

consideration – income + expenditure
+ amount remitted

The consideration Sally received is the repayment of the principal amount of $10,000 and the interest received of $1,050. The consideration Sally paid is the original deposit of $10,000 and the repayment of interest of $217.

The amount of income Sally derived in earlier income years is $700.

There is no expenditure from earlier years.

No amount is remitted.

Therefore, the BPA is:

($11,050 – $10,217) – $700 + $0 + $0
= $833 – $700
= $133

The positive BPA amount is income derived for Sally. The $133 for the 2018 income year reflects the receipt by Sally of interest income of $350 on 30 April 2017 and the repayment of interest of $217.

Partial withdrawal of term deposit amount

32. If a depositor only partially withdraws the deposit, there is no maturity of the financial arrangement. Therefore, no BPA is performed. In these circumstances, the deductibility of the repaid interest depends on whether the depositor is a cash basis person.

33. Note that this situation assumes the contract between the parties provides that the partial withdrawal of the deposit does not terminate the contract. If the withdrawal results in the existing term deposit contract being terminated and a new term deposit being entered into, a BPA will be required as discussed in [23] above.

Non-cash basis person

34. A depositor who is a non-cash basis person needs to apply *Determination G25: Variations in the Terms of a Financial Arrangement* when the term deposit is varied by the partial withdrawal.

35. The formula in Determination G25 is:

$$a - b - c + d$$

where:

a is the sum of all amounts that would have been income derived by the person in respect of the financial arrangement from the date it was acquired or issued to the end of the income year, if the changes had been known as at the date the financial arrangement was acquired or issued;

b is the sum of all amounts that would have been expenditure incurred by the person in respect of the financial arrangement from the date it was acquired or issued to the end of the income year, if the changes had been known as at the date the financial arrangement was acquired or issued;

c is the sum of all amounts treated as income derived of the person in respect of the financial arrangement since it was acquired or issued to the end of the previous income year;

d is the sum of all amounts treated as expenditure incurred of the person in respect of the financial arrangement since it was acquired or issued to the end of the previous income year.

36. The repaid interest will be brought into the Determination G25 calculation and an adjustment made in the year of variation. When the formula in Determination G25 is calculated, a positive amount is deemed to be income and a negative amount is deemed to be expenditure incurred. A BPA is done when the term deposit finally matures.

Example 3

37. Example 3 illustrates this situation.

Example 3

On 1 October 2015 Penny invests $10,000 for two years at 7%, with interest to be credited to her bank account six-monthly. She receives an interest payment of $350 on 31 March 2016. However, on 1 May 2016 Penny decides to withdraw $5,000 from the term deposit.

The term deposit contract states that on an early withdrawal the rate of interest is reduced to 5% on the amount of principal withdrawn. The reduced rate applies from the date of the original deposit, 1 October 2015. Therefore, the amount of interest Penny should have received for the $5,000 withdrawn is $146 (seven months interest at 5%). Penny has already been credited with $175 interest for the $5,000, so she owes the bank $29. The bank sets off the amount of interest owed against the amount of the principal to be repaid, and Penny receives $4,971 on 1 May 2016.

The balance of the principal remains in the term deposit and Penny receives interest payments of $175 on 30 September 2016 and 31 March 2017. On 30 September 2017, Penny receives $5,175, being the repayment of the remaining principal and the last interest payment.

Penny is not a cash basis person and has a standard balance date. If she has adopted the straight-line method, the results are as follows:

For the income year ending 31 March 2016, Penny has returned $350 of income.

For the income year ending 31 March 2017, Penny must apply the formula in Determination G25:

$a - b - c + d$

Item *a* is $671. This amount is made up of $525 of interest on the $5,000 not withdrawn (being $5,000 at 7% per annum for the 18 month period from 1 October 2015 to 31 March 2017) and $146 of interest on the $5,000 withdrawn (being $5,000 at 5% per annum for the seven months from 1 October 2015 to 1 May 2016).

Item *b* is nil, because if the changes had been known about at the start of the financial arrangement there would have been no expenditure. There would simply have been less income, which is taken into account in item a.

Item *c* is $350.

Item *d* is nil.

Therefore, applying the Determination G25 formula, the adjustment in the 2017 income year is:

$671 – $0 – $350 + $0
= $321

As the amount is positive, it is deemed to be income Penny derived for the year ending 31 March 2017. Essentially, the formula takes the $29 of repaid interest and deducts it from the income derived in the 2017 income year.

For the income year ending 31 March 2018, Penny will have to perform a BPA by applying the following formula:

consideration – income + expenditure
+ amount remitted

The consideration Penny received is the $10,000 principal repaid and the interest payments of $875 (being $350 on 31 March 2016 and $175 on 30 September 2016, 31 March 2017 and 30 September 2017). The consideration Penny paid is the $10,000 principal invested and the $29 repaid interest.

The amount of income Penny derived in earlier income years is $671 (being $350 in the 2016 income year and $321 in the 2017 income year).

There is no expenditure incurred in earlier income years.

No amount is remitted.

Therefore, the BPA is:

($10,875 – $10,029) – $671 + $0 + $0
= $846 – $671
= $175

As the BPA is positive, it is income derived by Penny. This equates with the interest income received by Penny in the 2018 income year. There is no adjustment for the repaid interest, because it was taken into account in the Determination G25 calculation in the previous income year.

Cash basis person

38. A person is a cash basis person if either:
    - the income and expenditure under all the person's financial arrangements for the income year does not exceed $100,000, or
    - the value of all the person's financial arrangements on every day of the income year does not exceed $1 million,

    and
    - the difference between the accrual treatment and the cash treatment of all the person's financial arrangements does not exceed $40,000 for the income year.
39. A cash basis person is not required to adopt a spreading method, although they may choose to do so.
40. If a depositor is a cash basis person and adopts a spreading method, they need to apply Determination G25 when the term deposit is varied by the partial withdrawal. This is the same as for a non-cash basis person and is covered in [34] to [36] above.
41. Where a cash basis person does not adopt a spreading method, expenditure incurred during the term of a financial arrangement will be deductible when it is incurred if the general permission is satisfied. In the present case, this means the repaid interest on a partial withdrawal would be deductible at the time of the withdrawal, rather than taken into account in the BPA on the eventual maturity of the term deposit.
42. However, to be deductible at the time of the withdrawal, the repaid interest must satisfy the general permission and none of the general limitations must apply.
43. The general permission in s DA 1 provides that a person is allowed a deduction for an amount of expenditure or loss to the extent to which the expenditure or loss is incurred by the person:

- in deriving their assessable income or excluded income or both, or
- in the course of carrying on a business for the purpose of deriving their assessable income or excluded income or both.

44. The leading New Zealand cases on the deductibility of expenditure are the Court of Appeal decisions in *CIR v Banks* (1978) 3 NZTC 61,236 and *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271. These cases establish that there must be a sufficient nexus between the expenditure incurred and the income earning process for the expenditure to be deductible.

45. In delivering the judgment of the court in *Banks*, Richardson J made the following comments at 61,241 and 61,242:

> For reasons such as these it seems clear that the application of the first limb must involve an amalgam of considerations. In the Australian cases … there has been considerable stress on the character of an outgoing in the sense of its being incidental and relevant to the gaining or producing of the assessable income. Statements to that effect emphasise the relationship that must exist between the advantage gained or sought to be gained by the expenditure and the income earning process. They do not, and cannot, specify in concrete terms the kind and degree of connection between the expenditure and the gaining or producing of assessable income required in individual cases for the expenditure to qualify for deduction. …
>
> Putting it positively, Dixon J. said in *Amalgamated Zinc (de Bavay's) Ltd v FC of T* (1935) 54 CLR 295, at p. 309 and we respectfully agree:
>
> 'The expression "in gaining or producing" has the force of "in the course of gaining or producing" and looks rather to the scope of the operations or activities and the relevance thereto of the expenditure than to purpose in itself.'
>
> It then becomes a matter of degree, and so a question of fact, to determine whether there is a sufficient relationship between the expenditure and what it provided, or sought to provide, on the one hand, and the income earning process, on the other, to fall within the words of the section.

46. In *Buckley & Young*, Richardson J stated at 61,274:

> It is not necessary for the purpose of this case to refer in any detail to the principles of deductibility under those provisions. There are two features of sec. 111 [of the Land and Income Tax Act 1954] which are of particular importance in this case. The first is that a deduction is available only where the expenditure has the necessary relationship both with the taxpayer concerned and with the gaining or producing of his assessable income or with the carrying on of a business for that purpose. The heart of the inquiry is the identification of the relationship between the advantage gained or sought to be gained by the expenditure and the income earning process. That in turn requires determining the true character of the payment. It then becomes a matter of degree and so a question of fact to determine whether there is a sufficient relationship between the expenditure and what it provided or sought to provide on the one hand, and the income earning process on the other, to fall within the words of the section (*C of IR v Banks* (1978) 3 NZTC 61,236, 61,242). The second feature of sec. 111 is that the statutory language contained in the phrase 'to the extent to which' expressly contemplates apportionment.

47. In *Cox v CIR* (1992) 14 NZTC 9,164 (HC), Williams J commented on the deductibility of expenditure incurred in carrying on a business, and stated at 9,168:

> While in jurisdictional terms para (b) is the narrower of the two limbs, it is generally recognised that for business taxpayers it facilitates deductibility in circumstances where a deduction might otherwise not be available under the first limb. This is so because it has been acknowledged in the authorities that the conduct of a business may require expenditures to be made which cannot be directly linked to the derivation of assessable income in some positive way, but which are made to, say, keep the enterprise on foot or to reduce expenditure: see *Europa Oil (supra)* at pp 61,196 and 61,197.
>
> The inclusion of the word "necessarily" in para (b) might mean that the paragraph is intended to be read in a restrictive sense, for example, disallowing deductions unless they are unavoidable or logically necessary for a business. However, the authorities have taken a more pragmatic and commercially realistic approach to business expenditures. Thus it is established by the cases that when compared to the older test laid down in sec 111 of the Land and Income Tax Act 1954, sec 104 has set a much wider and more commercially realistic test of deductibility of expenditure: *de Pelichet McLeod & Co Ltd v C of IR* (1982) 5 NZTC 61,216 at p 61,219. Moreover, whether an expenditure can be said to be necessarily incurred in the course of carrying on a business must be decided in each case on the facts and by way of a judgment based on common sense and business realities: *Europa Oil (NZ) Ltd (supra)* at pp 61,196 and 61,197.

48. The Commissioner considers these decisions remain relevant to the interpretation of s DA 1(1). Earlier provisions that correspond to s DA 1(1)(b) referred to "expenditure necessarily incurred in carrying on a business". Section DA 1 preserves the requirement for a sufficient nexus, notwithstanding that it has removed the word "necessarily". The Commissioner's considered view is that the word "necessarily" did no more than indicate a requirement that there be a sufficient degree of connection between the expenditure and the business.

49. Applying the principles from these cases requires asking whether there is a sufficient relationship between the repayment of the interest and the earning of assessable income. The Commissioner considers there is not a sufficient relationship between the repayment and the interest income earned under the term deposit for s DA 1(1)(a) to apply. The interest income is earned as a result of lending money. The advantage gained by the repayment is the ability to withdraw early from the term deposit contract, and therefore to cease earning the interest income. The repayment is not a cost of deriving the interest income; it is a cost of ceasing to derive the income. The repayment is a cost to the depositor of not fulfilling the terms of the contract between the bank and the depositor.

50. The repayment of the interest arises because of the depositor's decision to withdraw a portion of their funds before the maturity date. It is incurred solely because the depositor chooses to make a partial withdrawal; it is not incidental or relevant to the deriving of the earlier income.

51. The decision of the Commonwealth Taxation Board of Review in *Case 50* ((1958) 8 CTBR (NS) 250) also supports this approach. In *Case 50* the taxpayer was granted leave from his employment to attend university lectures, but he continued to receive his salary for the times he was absent from work, subject to certain conditions. The taxpayer breached those conditions when he later resigned to accept a higher-paid position, so he had to repay some of the salary he had received. The taxpayer claimed a deduction for the amount of salary repaid.

52. The Board of Review considered whether the payment satisfied the general deductibility test, and denied the deduction. The Board concluded at [7]:

> The liability on the taxpayer to repay the £412 arose directly from his failure to observe the conditions he had agreed to under which he had been paid salary in respect of periods of leave of absence granted to him for the purpose of attending lectures and examinations set down for the course of study undertaken by him. **The outgoing was not incurred by the taxpayer in the course of gaining or producing his assessable income .... The outgoing was not incidental or relevant to the gaining or producing of his assessable income but was incurred solely because of his failure to observe the conditions laid down when the leave was granted to him.**
>
> [Emphasis added]

53. This reasoning was also applied in *Case D19* 72 ATC 113, *Case F70* 74 ATC 421 and *Case G80* 75 ATC 564. While these cases concerned employment contracts, the Commissioner considers that the application of the general deductibility test in those cases is equally applicable in the context of the repayment of interest under a term deposit.

54. Where the amount of the repaid interest is not deductible at the time of repayment, it falls to be dealt with through the BPA on maturity of the deposit.

55. However, the Commissioner considers that a deduction may be available where the repayment of the interest was incurred in the course of carrying on a business for the purpose of deriving assessable income, or excluded income or a combination of both assessable and excluded income: s DA 1(1)(b). The courts take a pragmatic and commercially realistic approach to business expenditure. Whether there is a sufficient nexus for s DA 1(1)(b) to apply will depend upon the facts of each case. In this situation, s EW 31(3) and the BPA formula ensure that no double deduction can occur.

56. The amount of the repaid interest will be included in both the "consideration" and "expenditure" elements of the BPA calculation. Where a depositor partially withdraws a term deposit early and is required to repay interest derived in a previous income year, the application of the BPA at maturity will generally result in a positive amount. This reflects the receipt of interest income in the final year of the term deposit. Section EW 31(3) provides that a positive BPA amount is income derived by a person in the year the calculation is made. However, it is not income to the extent it arises from expenditure incurred under the financial arrangement in earlier income years and for which a deduction was denied. Therefore, the amount of interest income derived in the final year of the term deposit will be reduced by the amount of interest repaid in an earlier year. However, an amount of repaid interest for which a deduction was available (under s DA 1(1)(b)) will not reduce the amount of interest income derived in the final year of the term deposit. This ensures the depositor returns the correct amount of interest income over the full term of the deposit.

Example 4

57. Example 4 illustrates this for a non-business cash basis person:

Example 4

On 1 October 2015 Penny invests $10,000 for two years at 7%, with interest to be credited to her bank account six-monthly. She receives an interest payment of $350 on 31 March 2016. However, on 1 May 2016 Penny decides to withdraw $5,000 from the term deposit.

The term deposit contract states that on an early withdrawal the rate of interest is reduced to 5% on the amount of principal withdrawn. The reduced rate applies from the date of the original deposit, 1 October 2015. Therefore, the amount of interest Penny should have received for the $5,000 withdrawn is $146 (seven months interest at 5%). Penny has already been credited with $175 interest for the $5,000, so she owes the bank $29. The bank sets off the amount of interest owed against the amount of the principal to be repaid, and Penny receives $4,971 on 1 May 2016.

The balance of the principal remains in the term deposit and Penny receives interest payments of $175 on 30 September 2016 and 31 March 2017. On 30 September 2017, Penny receives $5,175, being the repayment of the remaining principal and the last interest payment.

These are the same facts as in Example 3 above, except that in the current example Penny is a cash basis person who chooses not to adopt a spreading method. Therefore, in this example, the results are as follows:

For the income year ending 31 March 2016, Penny will have returned income of $350.

For the income year ending 31 March 2017, Penny will have returned income of $350 (being the interest payments of $175 on 30 September 2016 and 31 March 2017). She will not be able to claim a deduction for the $29 repaid interest on 1 May 2016.

For the income year ending 31 March 2018, Penny will have to perform a BPA by applying the following formula:

consideration – income + expenditure
+ amount remitted

The consideration Penny received is the $10,000 principal repaid and the interest payments of $875 (being $350 on 31 March 2016, and $175 on 30 September 2016, 31 March 2017 and 30 September 2017). The consideration Penny paid is the $10,000 principal invested and the $29 repaid interest.

The amount of income derived in earlier income years is $700 (being $350 in each of the 2016 and 2017 income years).

The expenditure incurred in earlier income years is $29, being the amount of repaid interest.

There is no amount remitted.

Therefore, the BPA is:

($10,875 – $10,029) – $700 + $29 + $0
= $846 – $700 + $29
= $175

As the BPA is positive, it is income Penny derived. However, it is not income to the extent it arises from expenditure incurred in earlier years and for which a deduction was denied. A deduction was denied for the $29 repaid interest in the 2017 income year, so the positive BPA is reduced by that amount. Therefore, in the 2018 income year, Penny derives income of $146. This amount equates to the interest payment of $175 received on 30 September 2017, reduced by the interest repaid on 1 May 2016.

References

Expired Rulings
BR Pub 97/9 "Interest repayments imposed as a result of early repayment of a financial arrangement – deductibility" *Tax Information Bulletin* Vol 9, No 9 (September 1997): 5
BR Pub 10/21 "Interest repayments required as a result of the early repayment of a financial arrangement – deductibility" *Tax Information Bulletin* Vol 23, No 1 (February 2011): 15
Subject references
Deductions; Financial arrangements rules; Term deposits
Legislative references
Income Tax Act 2007 – ss DA 1, DB 6, DB 7, DB 11, EW 31
Case references
Arthur Murray (NSW) Pty Ltd v FCT (1965) 114 CLR 314 (HCA)
Bowcock v CIR (1981) 5 NZTC 61,062 (HC)
Buckley & Young Ltd v CIR (1978) 3 NZTC 61,271 (CA)
Case 50 (1958) 8 CTBR (NS) 250
Case D19 72 ATC 113
Case F70 74 ATC 421
Case G80 75 ATC 564
CIR v Banks (1978) 3 NZTC 61,236 (CA)
Cox v CIR (1992) 14 NZTC 9,164 (HC)
Other references
Determination G25: Variations in the Terms of a Financial Arrangement

APPENDIX – LEGISLATION

1. Section DA 1(1) and (2) provides:

DA 1 General permission

Nexus with income

(1) A person is allowed a deduction for an amount of expenditure or loss, including an amount of depreciation loss, to the extent to which the expenditure or loss is—

(a) incurred by them in deriving—

(i) their assessable income; or

(ii) their excluded income; or

(iii) a combination of their assessable income and excluded income; or

(b) incurred by them in the course of carrying on a business for the purpose of deriving—

(i) their assessable income; or

(ii) their excluded income; or

(iii) a combination of their assessable income and excluded income.

General permission

(2) Subsection (1) is called the **general permission**.

2. Section DA 2(1) provides:

DA 2 General limitations

Capital limitation

(1) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is of a capital nature. This rule is called the **capital limitation**.

3. Section DB 6(1) and (4) provides:

DB 6 Interest: not capital expenditure

Deduction

(1) A person is allowed a deduction for interest incurred.

…

Link with subpart DA

(4) This section overrides the capital limitation. The general permission must still be satisfied and the other general limitations still apply.

4. Section DB 7(1), (2) and (8) provides:

DB 7 Interest: most companies need no nexus with income

Deduction

(1) A company is allowed a deduction for interest incurred.

Exclusion: qualifying company

(2) Subsection (1) does not apply to a qualifying company.

…

Link with subpart DA

(8) This section supplements the general permission and overrides the capital limitation, the exempt income limitation, and the withholding tax limitation. The other general limitations still apply.

5. Section DB 11 provides:

DB 11 Negative base price adjustment

Deduction

(1) A person who has a negative base price adjustment under section EW 31(4) (Base price adjustment formula) is allowed a deduction for the expenditure to the extent to which it arises from assessable income, under section CC 3 (Financial arrangements), derived by the person under the financial arrangement in earlier income years.

Link with subpart DA

(2) This section supplements the general permission and overrides all the general limitations.

6. Section EW 3(2) and (3) provides:

EW 3 What is a financial arrangement?

…

Money received for money provided

(2) A financial arrangement is an arrangement under which a person receives money in consideration for that person, or another person, providing money to any person—

(a) at a future time; or

(b) on the occurrence or non-occurrence of a future event, whether or not the event occurs because notice is given or not given.

Examples of money received for money provided

(3) Without limiting subsection (2), each of the following is a financial arrangement:

(a) a debt, including a debt that arises by law:

(b) a debt instrument:

(c) the deferral of the payment of some or all of the consideration for an absolute assignment of some or all of a person's rights under another financial arrangement or under an excepted financial arrangement:

(d) the deferral of the payment of some or all of the consideration for a legal defeasance releasing a person from some or all of their obligations under another financial arrangement or under an excepted financial arrangement.

7. Section EW 29(3) provides:

EW 29 When calculation of base price adjustment required

…

Maturity

(3) A party to a financial arrangement must calculate a base price adjustment as at the date on which the arrangement matures.

8. Section EW 31 provides:

EW 31 Base price adjustment formula

Calculation of base price adjustment

(1) A person calculates a base price adjustment using the formula in subsection (5).

When formula applies

(2) The person calculates the base price adjustment for the income year in which section EW 29 applies to them.

Positive base price adjustment

(3) A base price adjustment, if positive, is income, under section CC 3 (Financial arrangements), derived by the person in the income year for which the calculation is made. However, it is not income to the extent to which it arises from expenditure incurred by the person under the financial arrangement in earlier income years and for which a deduction was denied in those income years.

Negative base price adjustment

(4) A base price adjustment, if negative, is expenditure incurred by the person in the income year for which the calculation is made. The person is allowed a deduction for the expenditure under sections DB 6 to DB 8 (which relate to deductions for interest) or, if none of those sections applies, under section DB 11 (Negative base price adjustment).

Formula

(5) The formula is—

consideration − income + expenditure
+ amount remitted

The *Definition of items in formula*

(6) The items in the formula are defined in subsections (7) to (11).

Consideration

(7) **Consideration** is all consideration that has been paid, and all consideration that is or will be payable, to the person for or under the financial arrangement, minus all consideration that has been paid, and all consideration that is or will be payable, by the person for or under the financial arrangement. For the purposes of this subsection, the following are ignored:

(a) non-contingent fees, if the relevant method is not the IFRS financial reporting method in section EW 15D:

(b) non-integral fees, if the relevant method is the IFRS financial reporting method in section EW 15D.

Consideration in particular cases

(8) If any of sections EW 32 to EW 48, or EZ 52D applies, the consideration referred to in subsection (7) is adjusted under the relevant section.

Income

(9) **Income** is—

(a) income derived by the person under the financial arrangement in earlier income years; and

(b) dividends derived by the person from the release of the obligation to repay the amount lent; and

(c) income derived under section CF 2(2) and (3) (Remission of specified suspensory loans).

Expenditure

(10) **Expenditure** is expenditure incurred by the person under the financial arrangement in earlier income years.

Amount remitted

(11) **Amount remitted** is an amount that is not included in the consideration paid or payable to the person because it has been remitted—

(a) by the person; or

(b) by law.

9. Section EW 54 provides:

EW 54 Meaning of cash basis person

Who is cash basis person

(1) A person is a **cash basis person** for an income year if—

(a) 1 of the following applies in the person's case for the income year:

(i) section EW 57(1); or

(ii) section EW 57(2); and

(b) section EW 57(3) applies in the person's case for the income year.

Persons excluded by Commissioner

(2) A person may be excluded under section EW 59 from being a cash basis person for a class of financial arrangements.

10. Section EW 55 provides:

EW 55 Effect of being cash basis person

Use of spreading method

(1) A cash basis person is not required to apply any of the spreading methods to any of their financial arrangements, but may choose to do so under section EW 61.

Calculation of base price adjustment

(2) The fact that a cash basis person does not use any of the spreading methods for the financial arrangement does not excuse them from the requirement to calculate a base price adjustment when any of section EW 29(1) to (12) applies to them.

11. Section EW 57 provides:

EW 57 Thresholds

Income and expenditure threshold

(1) For the purposes of section EW 54(1)(a)(i), this subsection applies if the absolute value of the person's income and expenditure in the income year under all financial arrangements to which the person is a party is $100,000 or less.

Absolute value threshold

(2) For the purposes of section EW 54(1)(a)(ii), this subsection applies if, on every day in the income year, the absolute value of all financial arrangements to which the person is a party added together is $1,000,000 or less. The value of each arrangement is,—

(a) for a fixed principal financial arrangement, its face value:

(b) for a variable principal debt instrument, the amount owing by or to the person under the financial arrangement:

(c) for a financial arrangement to which the old financial arrangements rules apply, the value determined under those rules.

Deferral threshold

(3) For the purposes of section EW 54(1)(b), this subsection applies if the result of applying the formula in subsection (4) to each financial arrangement to which the person is a party at the end of the income year and adding the outcomes together is $40,000 or less.

Formula

(4) The formula is—

(accrual income − cash basis income) + (cash basis expenditure − accrual expenditure).

Definition of items in formula

(5) The items in the formula are defined in subsections (6) to (9).

Accrual income

(6) **Accrual income** is the amount that would have been income derived by the person under the financial arrangement if the person had been required to use a spreading method in the period starting on the date on which they became a party to the arrangement and ending on the last day of the income year for which the calculation is made. It is calculated using 1 of the following methods, as chosen by the person:

(a) the yield to maturity method, whether or not the person may use it, or has chosen to use it, for their financial arrangement; or

(b) the straight-line method, whether or not the person may use it, or has chosen to use it, for their financial arrangement; or

(c) an alternative method approved by the Commissioner.

Cash basis income

(7) **Cash basis income** is the amount that would have been income derived by the person under the financial arrangement if the person had been a cash basis person in the period starting on the date on which they became a party to the arrangement and ending on the last day of the income year for which the calculation is made.

Cash basis expenditure

(8) **Cash basis expenditure** is the amount that would have been expenditure incurred by the person under the financial arrangement if the person had been a cash basis person in the period starting on the date on which they became a party to the arrangement and ending on the last day of the income year for which the calculation is made.

Accrual expenditure

(9) **Accrual expenditure** is the amount that would have been expenditure incurred under the financial arrangement if the person had been required to use a spreading method in the period starting on the date on which they became a party to the arrangement and ending on the last day of the income year for which the calculation is made. It is calculated using 1 of the following methods, as chosen by the person:

(a) the yield to maturity method, whether or not the person may use it, or has chosen to use it, for their financial arrangement; or

(b) the straight-line method, whether or not the person may use it, or has chosen to use it, for their financial arrangement; or

(c) an alternative method approved by the Commissioner.

Increase in specified sums

(10) The Governor-General may make an Order in Council increasing a sum specified in any of subsections (1) to (3).

12. In s YA 1, the definitions of "interest", "maturity", "non-contingent fee" and "non-integral fee" relevantly read:

> **interest,—**
>
> …
>
> (c) in sections DB 6 (Interest: not capital expenditure), DB 7 (Interest: most companies need no nexus with income), and DB 8 (Interest: money borrowed to acquire shares in group companies),—
>
> (i) includes expenditure incurred under the financial arrangements rules or the old financial arrangements rules
>
> …
>
> **maturity,—**
>
> (a) in the financial arrangements rules, means,—
>
> (i) for an agreement for the sale and purchase of property or services or an option, the date on which the agreement or option ends:
>
> (ii) for any other financial arrangement, the date on which the last payment contingent on the financial arrangement is made:
>
> …
>
> **non-contingent fee** means a fee that—
>
> (a) is for services provided for a person becoming a party to a financial arrangement; and
>
> (b) is payable whether or not the financial arrangement proceeds
>
> **non-integral fee** means a fee or transaction cost that, for the purposes of financial reporting under IFRSs, is not an integral part of the effective interest rate of a financial arrangement.

PUBLIC RULING BR PUB 14/08: INCOME TAX – TIMING OF DISPOSAL AND DERIVATION OF INCOME FROM TRADING STOCK

This is a reissue of an expired ruling BR Pub 04/06 *Trading stock – tax treatment of sales and agreements to sell.* For more information about the history of this ruling see the background in the commentary.

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

Taxation Laws

All legislative references are to the Income Tax Act 2007 unless otherwise stated.

This Ruling applies in respect of ss CB 1, CB 2, EB 2, and YA 1 (definition of "trading stock").

The Arrangement to which this Ruling applies

The Arrangement is a sale or disposal of property (including a contract of sale of, and an agreement to sell, property) that is part of the trading stock of a business owned or carried on by the vendor. This includes the disposal of trading stock together with other assets of a business.

How the Taxation Laws apply to the Arrangement

The Taxation Laws apply to the Arrangement as follows:

- When a person sells trading stock in the ordinary course of business, s CB 1 applies to include amounts that are "derived" from the sale within the income of the person. Amounts are derived when the income is earned, being when a legally enforceable debt arises, or the right to be paid otherwise crystallises.
- If trading stock is sold outside the ordinary course of business, or to put an end to the business or part of it, s CB 2 applies to include all amounts received from the "disposal of" the trading stock within the income of the person. The date of disposal differs, depending on whether a clearly expressed intention of the parties exists as to when property in the trading stock is to pass:
  - The date of disposal will be the date the parties intended property in the goods to pass if a clearly expressed intention as to the time of passing of property is evident from the terms of the contract, the conduct of the parties and the circumstances of the case. Circumstances of the case that may be relevant include whether the contract includes a reservation of title or Romalpa clause.
  - If no clearly expressed intention as to the time of passing of property can be determined, the date of disposal will be decided according to the appropriate statutory rule in s 20 of the Sale of Goods Act 1908 as follows:
    - If there is an unconditional contract for goods that are specific and in a deliverable state—the date the contract becomes unconditional.
    - If the vendor must do something to make such goods deliverable—the date such action is completed, and the buyer is notified.
    - If the vendor must weigh, measure, or test such goods to ascertain the selling price—the date such action is completed and the buyer is notified.
    - If goods are delivered to a buyer on "sale or return" or similar terms—the time at which the buyer signifies their approval or retains the goods without notifying rejection within an agreed or reasonable timeframe.
    - If unascertained or future goods are sold by description—when the goods are in a deliverable state and unconditionally appropriated to the contract by either party with the assent of the other.
- Where s CB 2 applies to a disposal of trading stock, s CB 2(3) provides that the purchaser is treated as acquiring the trading stock for the amount that is treated as income of the vendor.

The period for which this Ruling applies

This Ruling will apply for an indefinite period beginning on the first day of the 2014–15 income year.

This Ruling is signed by me on 30 September 2014.

Susan Price
Director, Public Rulings

COMMENTARY ON PUBLIC RULING BR PUB 14/08

This commentary is not a legally binding statement. The commentary is intended to help readers understand and apply the conclusions reached in Public Ruling BR Pub 14/08 (the ruling).

Legislative references are to the Income Tax Act 2007 unless otherwise stated.

Summary

1. This commentary considers the key issues:
   - Whether s CB 1 or s CB 2 applies when trading stock is sold;
   - When receipts from the sale of trading stock are "derived";
   - When trading stock is "disposed of".
2. Whether s CB 1 or s CB 2 applies depends on whether the trading stock has been sold in the ordinary course of business. Sections CB 1 and CB 2 operate in tandem to ensure all disposals of trading stock give rise to income for tax purposes. However, the timing of when the income arises differs depending on which section applies. Where the trading stock has been disposed of in the ordinary course of business, s CB 1 will apply. This means income arises when it has been derived. Section CB 2 will apply where the trading stock is disposed of outside the ordinary course of business or to put an end to the business or part of it. If s CB 2 applies, income arises at the time the trading stock is disposed of.
3. Income from the sale of trading stock in the ordinary course of business is derived when the income is earned, being when a legally enforceable debt arises or the right to be paid otherwise crystallises.
4. Where s CB 2 applies, trading stock is disposed of when property in the trading stock passes. When property passes depends on whether the parties have clearly expressed their intention as to when property is to pass between them. If they have, property passes and trading stock is disposed of at the date the parties intended. Otherwise, trading stock is disposed of on the date determined according to the appropriate statutory rules in ss 20 or 21 of the Sale of Goods Act 1908 (SGA).
5. The ruling and commentary do not consider the effects of the financial arrangements rules in Part EW of the Act.

Background

6. This ruling is a reissue of BR Pub 04/06 that applied until the end of the 2008 income year and was published in *Tax Information Bulletin* Vol 16, No 5 (June 2004): 17. BR Pub 04/06 was a reissue of an earlier ruling BR Pub 98/8 *Trading stock – tax treatment of disposals* published in *Tax Information Bulletin* Vol 11, No 1 (January 1999): 3.
7. The previous ruling, BR Pub 04/06, set out when ss CD 3 and FB 3 of the Income Tax Act 1994 applied because these sections appeared to overlap in their application. This ambiguity was clarified in the Income Tax Act 2007.
8. The previous ruling also included analysis of when an amount from the sale or disposal of trading stock was "derived" under s CD 3 and when trading stock was "sold or disposed of" under s FB 3. The previous ruling included this analysis because there had been some confusion about when income arises where a business disposes of trading stock.
9. Sections CB 1 and CB 2 are the provisions in the Income Tax Act 2007 that correspond to the former ss CD 3 and FB 3 of the Income Tax Act 1994. The 2007 Act did not alter the timing of when income is derived from trading stock. There has been a minor change in s CB 2, which now refers to trading stock "disposed of" rather than "sold or disposed of". The Commissioner considers that this change does not alter the timing of when trading stock is disposed of.

The issues

10. The key issues are:
    - Whether s CB 1 or s CB 2 applies;
    - When receipts from the sale of trading stock are "derived";
    - When trading stock is "disposed of".

Whether s CB 1 or s CB 2 applies

11. As stated, the Income Tax Act 2007 has clarified whether s CB 1 or s CB 2 applies where there has been a disposal of trading stock. Section CB 1 includes within a person's income an amount they derive from a business. If sales of trading stock occur in the ordinary course of business, s CB 1 will apply to include such amounts within income.
12. However, s CB 2(5) provides that s CB 2 overrides s CB 1. So, s CB 2 will apply instead of s CB 1 to sales of trading stock outside the ordinary course of business or sales that put an end to the business or part of it. Generally, s CB 2 applies to larger transactions involving other assets and/or multiple items of trading

stock where the sale is more akin to the sale or disposal of a group of business assets.

13. It is important to establish which section applies to determine the timing of income from sales of trading stock. This is because s CB 1 includes in income receipts from the sale of trading stock when they are "derived". In contrast, s CB 2 includes in income such receipts when the trading stock is "disposed of". These two points in time can be different. In practice, the difference is most likely to matter when a transaction straddles a balance date.

Section CB 1 – when receipts from the sale of trading stock are "derived"

14. Amounts received from the sale of trading stock sold in the ordinary course of business will give rise to business income that becomes the income of the person under s CB 1 when the business income is "derived".

15. It is settled law that the word "derived" means more than merely received. It connotes the source or origin rather than the fund or place from which the income was taken, and means flowing, springing, or emanating from, or accruing: *CIR v NV Philips Gloeilampenfabrieken* [1955] NZLR 868 (CA).

16. It is also settled law that the timing of derivation and the method of accounting for income "should be that which is calculated to give a substantially correct reflex of the taxpayer's true income": *Commissioner of Taxes (SA) v The Executor Trustee and Agency Co of South Australia Ltd* (1938) 63 CLR 108 (HCA) (*Carden's Case*); *Philips*; *CIR v Farmers' Trading Co Ltd* [1982] 1 NZLR 449, (1982) 5 NZTC 61,200 (CA).

17. For most business taxpayers, the most appropriate method of accounting to give a substantially correct reflex of their business income will be the accrual method of accounting. This means income could be derived even if payment has not yet been received or an invoice rendered.

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

19. The leading New Zealand case on the relevance of accounting principles and derivation is *Farmers' Trading*. This case dealt with when business profits were derived from trading stock sold where the customer paid the purchase price over a period of five months by way of monthly instalments. The issue was whether the income was derived at the time the stock was sold or whether a "profit emerging" approach could be used to spread the income over a period. It was held that the sales were fundamentally different to hire purchase sales. This was because the title and the property passed with the possession of the goods and the vendor could only sue for unpaid instalments. It was also held that the business profits were derived when the stock was sold and a debt in favour of the vendor was created.

20. Richardson J cited *Carden's Case* with approval. In particular, he restated that "the foundation of the accrual system is the view that the accounts should show at once the liabilities incurred and the revenue earned, independently of the date when payment is made or becomes due". His Honour stated at 61,208:

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

21. See, also, the Australian High Court case of *J Rowe and Son Pty Ltd v FCT* 71 ATC 4157, which is consistent with the principles expressed in *Farmers' Trading* in its rejection of the "profit emerging" approach.

22. The general principle that income is derived when it is earned, and that this is when there is an entitlement to payment or a legally enforceable debt, was also applied

in *Hawkes Bay Power Distribution Ltd v CIR* (1999) 19 NZTC 15,226 (CA). In that case, Richardson P delivered the judgment of the Court of Appeal, which essentially agreed with Goddard J's conclusion in the High Court, that the taxpayer's income was derived when electricity was supplied by the taxpayer and used by its customers. The Court of Appeal considered that the income earning process was complete on supply and sale of the electricity to the consumer.

Section CB 2 – when trading stock is "disposed of"

23. Section CB 2 applies where a business disposes of trading stock either outside of the ordinary course of business or to put an end to the business, or a part of it. Where trading stock is disposed of together with other assets of a business, s EB 24 requires the total amount received to be apportioned between the trading stock and the other assets in a way that reflects their respective market values.

24. The question of when stock is "disposed of" becomes important when s CB 2 applies. This is a different question to when income is "derived". Section CB 2(4) defines "disposal" as including "the passing of property by an exchange, gift, distribution under a will or on intestacy". A disposal under ss FC 3 to FC 8 (which relate to distributions after death) that is not at market value is not included. The definition is silent on the timing of a disposal, but some guidance is given by case law and the SGA.

Sale of Goods Act 1908

25. Section CB 2(4)(a) states that disposal includes the passing of property by various means. The "passing of property" is a concept also used in the SGA. The SGA shows that a disposal or a sale of goods occurs when property in those goods passes to the purchaser.

26. Note that the SGA recognises a distinction between a "contract of sale of goods" and an "agreement to sell". There is a "contract of sale of goods" when a seller agrees to transfer property in the goods for a consideration called the "price". A sale occurs once the property in the goods is transferred from the seller to the buyer. In contrast, there is an "agreement to sell" when the transfer of property in the goods is to take place either at some future time or is subject to the fulfilment of some condition. A sale occurs either when the time elapses or the conditions are fulfilled.

27. The timing of when property in goods passes to a purchaser under the SGA depends on whether the goods are specific or unascertained. The term "unascertained goods" is not defined in the SGA, but *Commercial Law in New Zealand* (online looseleaf ed, LexisNexis) states at [11.2]:

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

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

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

The timing when the parties agree

30. Sections 19(1) and (2) of the SGA provide that where there is a contract for the sale of specific or ascertained goods, the property in the goods is transferred from the seller to the buyer at the time the parties to the contract intended property to be transferred. When finding out the intention of the parties, regard should be had to the terms of the contract, the conduct of the parties, and the circumstances of the case. Accordingly, any explicit intention of the parties as to when property in the goods passes will be recognised as the date the sale occurs.

31. Other factors, such as whether the agreement for sale includes a reservation or retention of title clause, commonly known as a Romalpa clause, may be relevant. These clauses are designed to ensure that property in the goods is kept with the vendor until payment is received. Section 21 of the SGA sets out the rules for when property passes in these cases:

> *21 Reservation of right of disposal*
>
> (1) Where there is a contract for the sale of specific goods, or where goods are subsequently appropriated to the contract, the seller may, by the terms of the contract or appropriation, reserve the right of disposal of the goods until certain conditions are fulfilled.
>
> (2) In such case, notwithstanding the delivery of the goods to the buyer, or to a carrier or other bailee for the purpose of transmission to the buyer, the property in the goods does not pass to the buyer until the conditions imposed by the seller are fulfilled.

(3) Where goods are shipped, and by the bill of lading the goods are deliverable to the order of the seller or his agent, the seller is prima facie deemed to reserve the right of disposal.

(4) Where the seller of goods draws on the buyer for the price, and transmits the bill of exchange and bill of lading to the buyer together to secure acceptance or payment of the bill of exchange, the buyer is bound to return the bill of lading if he does not honour the bill of exchange, and if he wrongfully retains the bill of lading the property in the goods does not pass to him.

The timing when the parties' agreement is not evident

32. Where the parties either have not formed an intention as to when property passes, or have not clearly expressed their intention, s 20 of the SGA sets out five rules for determining when the property in the goods will be deemed to have passed. The first of these rules is considered the most common and relevant to trading stock. Section 20 states:

Rules for ascertaining intention

Unless a different intention appears, the following are rules for ascertaining the intention of the parties as to the time at which the property in the goods is to pass to the buyer:

Rule 1 Where there is an unconditional contract for the sale of specific goods, in a deliverable state, the property in the goods passes to the buyer when the contract is made, and it is immaterial whether the time of payment or the time of delivery, or both, is postponed.

Rule 2 Where there is a contract for the sale of specific goods, and the seller is bound to do something to the goods for the purpose of putting them into a deliverable state, the property does not pass until such thing is done, and the buyer has notice thereof.

Rule 3 Where there is a contract for the sale of specific goods in a deliverable state, but the seller is bound to weigh, measure, test, or do some other act or thing with reference to the goods for the purpose of ascertaining the price, the property does not pass until such act or thing is done, and the buyer has notice thereof.

Rule 4 Where goods are delivered to the buyer on approval, or on sale or return or other similar terms, the property therein passes to the buyer—

(a) when he signifies his approval or acceptance to the seller, or does any other act adopting the transaction:

(b) if he does not signify his approval or acceptance to the seller, but retains the goods without giving notice of rejection then, if a time has been fixed for the return of the goods, on the expiration of such time, and if no time has been fixed, on the expiration of a reasonable time. What is a reasonable time is a question of fact.

Rule 5 (1) Where there is a contract for the sale of unascertained or future goods by description, and goods of that description and in a deliverable state are unconditionally appropriated to the contract, either by the seller with the assent of the buyer or by the buyer with the assent of the seller, the property in the goods thereupon passes to the buyer. Such assent may be expressed or implied, and may be given either before or after the appropriation is made.

(2) Where, in pursuance of the contract, the seller delivers the goods to the buyer, or to a carrier or other bailee (whether named by the buyer or not) for the purpose of transmission to the buyer, and does not reserve the right of disposal, he is deemed to have unconditionally appropriated the goods to the contract.

[Emphasis added]

Date of disposal for s CB 2

33. There is no New Zealand case law on the effect of the SGA on s CB 2 (or its predecessors). The Australian Commonwealth Taxation Board of Review referred to the Australian Sale of Goods Act when deciding in *Case 18* (1946) 12 CTBR 120 that property had been disposed of by way of sale when the contract became unconditional. The issue in *Case 18* was whether the taxpayer's property had been "disposed of by sale or otherwise howsoever ..." for s 36(1) of the Australian Income Tax Assessment Act 1936 (now s 70–85 of the Income Tax Assessment Act 1997). The Chairman of the Board of Review noted, in relation to the sale of goods, at 126:

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

34. There is a similarity between the Australian and New Zealand Sale of Goods Acts that reflects their common United Kingdom origins. Also, the trading stock provisions in the Australian Income Tax Assessment Act 1936 are similar in both their wording and treatment of trading stock to the equivalent New Zealand provisions. This means that, when dealing with the disposal of personal property, *Case 18* is authority for looking at non-tax legislation for guidance on when property is disposed of for tax purposes.

35. In *Hansen v CIR* [1972] NZLR 193, the Court of Appeal considered the precursor to s EB 24 (Apportionment on disposal of business assets that include trading stock). The issue was whether the Commissioner could determine the value of sheep sold as trading stock along with the other assets of the business, regardless of the parties having agreed a price for the sheep. Relevantly, the court gave effect to the intentions of the parties for when property in the stock passed. The purchaser was not allowed to shear the sheep before settlement. This suggested that the purchaser did not own the stock until settlement. The court concluded that settlement date was the appropriate date to value the sheep for the purposes of calculating their sale price. This was the date the parties intended property to pass to the purchaser and when the sheep were sold.

36. The general principle is that the date of sale (and, therefore, disposal) occurs when property in the goods passes. When an express intention of the parties as to when property passes can be found, that will be the date of sale. If no intention is expressed or can be found, the date of sale will be decided according to the statutory rules or presumptions contained in s 20 of the SGA (commonly the date an unconditional contract exists). Although not in the context of s CB 2, this general approach has also been upheld in tax cases that have referred to ss 19 and 20 of the SGA to decide when property has passed: *CIR v International Importing Ltd* [1972] NZLR 1,095 (CA); *Verryt v CIR* (1990) 12 NZTC 7,107 (HC).

37. Accordingly, for s CB 2, trading stock is "disposed of" when property in the goods passes. This will occur when the parties intend property to pass, where an express intention can be found. If no intention can be found, the statutory presumptions contained in Rules 1 to 5 of s 20 of the SGA will decide when property passes, and therefore when a sale or disposition occurs. Section 21 of the SGA may also be relevant where the contract includes a Romalpa clause.

38. Where s CB 2 applies to a disposal of trading stock, s CB 2(3) provides that the purchaser is treated as acquiring the trading stock for the amount that is treated as income of the vendor.

When a contract is unconditional

39. As Rule 1 of s 20 of the SGA relates to unconditional contracts, it is important to understand when a contract becomes unconditional.

40. An agreement becomes a binding contract when both parties to the contract have entered into binding obligations. A contract becomes unconditional when a binding contract is not subject to any conditions that may prevent the performance of the contract and the parties could sue for specific performance. A useful summary of the current state of New Zealand law on conditional contracts is in *Laws of New Zealand* Contract (online ed) at [154]:

> New Zealand Courts have developed a body of law concerning conditional contracts in which the term "condition" refers to a contingent condition; this is a provision in an agreement that contemplates that the legal effect of, or the parties' obligations under, the agreement will be altered in some way on the occurrence or non-occurrence of the contemplated contingency. In many older cases conditions were simply classified as "conditions precedent" or "conditions subsequent", a practice which led to real confusion in case law. The term "condition subsequent" is still commonly used without such a reference point and generally refers to a contingency which is to occur, or not, at some point after a binding contract has been entered and on which the continuation of contractual obligations depend; this means that a failure to fulfil the condition will bring the contract to an end at that point or will give to one or both parties the option to bring the contract to an end. The term "condition precedent" was particularly productive of confusion since a condition might be a contingency required to occur before an agreement came to have contractual force or alternatively a contingency which was to occur after the contract was entered into but before some aspect of performance was required. There has been judicial criticism of the use of the terms "condition subsequent" and "condition precedent" unless the discussion of the condition in question makes it clear what precisely it is that the condition is precedent to or subsequent to. It is therefore now more common for the Courts to concern themselves with the effect of the particular condition before them on the particular contract; however, it is possible to formulate general rules which indicate the likely effect of such common conditions as making agreements subject to contract or subject to finance or subject to solicitor's approval.
>
> [Footnotes omitted]

See also *Laws of New Zealand* Sale of Goods (online ed) [80] for a discussion of unconditional contracts under the SGA.

Financial arrangements rules

41. The ruling does not consider any potential operation of the financial arrangements rules in subpart EW. If the financial arrangements rules apply, the approach in the ruling will apply to any consideration that is effectively attributed as the value of the trading stock sold, as opposed to the total amount paid (where any difference is treated as interest under the financial arrangements rules).

Examples

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

Example 1: Ordinary course of business – payment with possession

43. A customer enters a sporting goods store and purchases a tennis racquet, which comes with a 30 day money-back guarantee if not completely satisfied. The customer pays and leaves in possession of the goods.

44. The income from the sale is derived by the store in terms of s CB 1 on the day the customer purchases the tennis racquet. The tennis racquet is sold in the ordinary course of business and the income has been earned (and therefore derived), regardless of whether the customer returns at a later date seeking a refund under the guarantee.

Example 2: Ordinary course of business – two instalments

45. On 12 March, a large appliance store and a customer sign a sale and purchase agreement for the sale of a refrigerator. The agreement allows for the refrigerator to be delivered that day on payment of a 25% deposit. The contract provides that risk passes to the customer on delivery of the refrigerator, but property does not pass until payment of the balance of the purchase price. Payment of the balance of the purchase price occurs one month later.

46. The income from the sale is derived in terms of s CB 1 on 12 March, as it is a sale of trading stock in the ordinary course of business. On that day, the income has been earned and a legally enforceable debt arose when the purchaser took delivery of the refrigerator.

Example 3: Ordinary course of business – mail order

47. A customer makes a bulk order for photocopiers from an office equipment supplier by way of mail order from a catalogue description. The order is posted on 12 September and received by the vendor on 15 September. The photocopiers are taken from the vendor's warehouse and shipped on 20 September, with delivery to the customer taking place the next day.

48. The standard terms of sale are that risk, title and property in the goods pass when the goods are put onto the delivery truck. The photocopiers are delivered with an invoice showing payment is due on 20 October, which is when the customer pays for the photocopiers.

49. As this sale is made in the ordinary course of operating an office equipment supply business, the income from the sale is taxed under s CB 1. The income is derived on 20 September, when the trading stock is shipped. On that day the income has been earned and a debt has become due and enforceable under the terms of the sale.

50. If the sale conditions were that risk, title and property in the goods did not pass until delivery, the income would be derived on 21 September. In that situation, no debt is enforceable until delivery occurs.

Example 4: Sale in course of closing down business

51. As in example 3, a customer places an order with the same standard terms of sale that property in the goods passes when the goods are put onto the delivery truck. However, for the purpose of this example, assume that the vendor is making the sale in the course of closing down the part of its business relating to office equipment, so that s CB 2 applies. As s CB 2 applies, the time of disposal of the trading stock is relevant, rather than when income from the sale of the trading stock would otherwise have been derived under s CB 1.

52. The order is for generic items that are unascertained goods at the time the order is made. The goods do not become specific goods until the particular photocopiers are identified as the customer's. Without any clear contractual intention to the contrary, this would occur on 20 September. On that day, the photocopiers are appropriated to the order or contract, property passes and a disposal occurs.

Example 5: Sale in course of closing down business – reservation of title

53. As in example 4, a customer places an order in circumstances where it is assumed the vendor is making the sale in the course of closing down the part of its business relating to office equipment, so that s CB 2 applies. In this example, the terms of sale include a reservation of title clause that ensures the property in the goods does not pass until the goods are paid for in terms of s 21 of the SGA.

54. Despite the goods becoming specific goods when the photocopiers are appropriated to the order and are shipped on 20 September, property does not pass and a disposal does not occur until 20 October, when payment is made.

References

Expired Ruling
BR Pub 04/06 "Trading stock – tax treatment of sales and agreements to sell" *Tax Information Bulletin* Vol 16, No 5 (June 2004): 17
Subject references
Derivation of income; Time of sale; Trading stock
Legislative references
Income Tax Act 2007 – ss CB 1, CB 2, EB 2, EB 24, and YA 1 (definition of "trading stock")
Sale of Goods Act 1908 – ss 2, 3, 18, 19, 20 and 21
Case references
Case 18 (1946) 12 CTBR 120
CIR v Farmers' Trading Co Ltd [1982] 1 NZLR 449, (1982) 5 NZTC 61,200 (CA)
CIR v International Importing Ltd [1972] NZLR 1,095 (CA)
CIR v NV Philips Gloeilampenfabrieken [1955] NZLR 868 (CA)
Commissioner of Taxes (SA) v The Executor Trustee and Agency Co of South Australia Ltd (1938) 63 CLR 108 (HCA) (Carden's Case)
Hansen v CIR [1972] NZLR 193 (CA)
Hawkes Bay Power Distribution Ltd v CIR (1999) 19 NZTC 15,226 (CA)
J Rowe and Son Pty Ltd v FCT 71 ATC 4157 (HCA)
Re Gold Corp Exchange Ltd (In Rec) [1994] 3 NZLR 385 (PC)
Re Wait [1927] 1 Ch 606
Verryt v CIR (1990) 12 NZTC 7,107 (HC)
Other References
Commercial Law in New Zealand (online looseleaf ed, LexisNexis)
Laws of New Zealand (online ed)

APPENDIX – LEGISLATION

1. Section CB 1(1) states:

CB 1 Amounts derived from business

Income

(1) An amount that a person derives from a business is income of the person.

2. Section CB 2 states:

CB 2 Amounts received on disposal of business assets that include trading stock

When this section applies

(1) This section applies in an income year when—

(a) a person (**person A**) who owns or carries on a business disposes of some or all of the assets of the business to another person (**person B**); and

(b) the disposal is made outside the ordinary course of the business, or to put an end to the business or a part of it; and

(c) the assets consist of or include trading stock of the business, or a share or interest in trading stock.

Assessable income of person A

(2) An amount that person A receives from the disposal of the trading stock is taken into account in determining their income for the income year. The amount is derived at the time of disposal referred to in subsection (1).

Price of acquisition by person B

(3) In the calculation of the taxable income of person B for the income year or a later income year, person B is treated as acquiring the trading stock for the amount of the disposal referred to in subsection (2).

Disposal

(4) In this section, a disposal—

(a) includes the passing of property by an exchange, gift, distribution under a will or on intestacy; and

(b) does not include a disposal under any of sections FC 3 to FC 8 (which relate to distributions after death) that is not at market value.

Relationship with section CB 1

(5) This section overrides section CB 1.

3. Section YA 1 defines "trading stock" as:

trading stock—

(a) is defined in section EB 2 (Meaning of trading stock) except for the provisions to which paragraphs (b) and (d) apply:

(b) in sections CG 6 (Receipts from insurance, indemnity, or compensation for trading stock), EB 24 (Apportionment on disposal of business assets that include trading stock), FB 13 (Trading stock), and GC 1 to GC 3 (which relate to the sale of trading stock for inadequate consideration),—

(i) includes anything produced or manufactured:

(ii) includes anything acquired for the purposes of manufacture or disposal:

(iii) includes livestock:

(iv) includes timber or a right to take timber:

(v) includes land whose disposal would produce income under any of sections CB 6 to CB 15 (which relate to income from land):

(vi) includes any thing for which expenditure is incurred and which would be trading stock if possession of it were taken:

(vii) does not include a financial arrangement to which the financial arrangements rules or the old financial arrangements rules apply:

(c) for the purposes of section GC 1 (Disposals of trading stock at below market value), has an expanded meaning as set out in section GC 1(4):

(d) in the old financial arrangements rules, is defined in section EZ 48 (Definitions)

4. Section EB 2 defines trading stock as:

EB 2 Meaning of trading stock

Meaning

(1) **Trading stock** means property that a person who owns or carries on a business has for the purpose of selling or exchanging in the ordinary course of the business.

Inclusions

(2) **Trading stock** includes—

(a) work of the following kinds that would be trading stock under subsection (1) if it were completed:

(i) partly completed work:

(ii) work in progress:

(b) materials that the person has for use in producing trading stock:

(c) property on which the person has incurred expenditure, when the property would, if they had it, be trading stock under subsection (1) or paragraph (a) or (b):

(d) property leased under a hire purchase agreement when the property—

(i) is treated as having been acquired by the lessor under section FA 15 (Treatment when agreement ends: seller acquiring property); and

(ii) is an asset of a business that the lessor carries on.

Exclusions

(3) **Trading stock** does not include—

(a) land:

(b) depreciable property:

(c) a financial arrangement to which the financial arrangements rules or the old financial arrangements rules apply:

(d) an excepted financial arrangement that a life insurer has:

(e) an excepted financial arrangement held by a person if section CX 55 (Proceeds from disposal of investment shares) applies to the income of the person from a disposal of the excepted financial arrangement:

(f) livestock not used in a dealing business:

(g) consumable aids to be used in the process of producing trading stock:

(h) a spare part not held for sale or exchange:

(i) an emissions unit:

(j) a non-Kyoto greenhouse gas unit.

PRODUCT RULING BR PRD 14/09: RABO CAPITAL AND RABOBANK NEDERLAND

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

Persons to whom the Ruling applies ("the Applicants")

This Ruling has been applied for by:

- Coöperatieve Centrale Raiffeisen-Boerenleenbank B.A. ("Rabobank Nederland"); and
- Rabo Capital Securities Limited ("Rabo Capital").

Taxation Laws

All legislative references are to the Income Tax Act 2007 ("the Act") unless otherwise stated.

This Ruling applies in respect of sections CX 56C, GB 35, BG 1 and GA 1.

The Arrangement to which this Ruling applies

The Arrangement is the raising of capital by Rabo Capital and Rabobank Nederland. Rabo Capital offered to the public (in New Zealand and to investors in other jurisdictions where they may be lawfully offered) New Zealand dollar denominated, perpetual, non-cumulative, non-voting preference shares ("PIE Capital Securities") of up to $200 million (with the option to accept unlimited oversubscriptions at its discretion). On 25 May 2009 Rabo Capital accepted applications of $280 million. The PIE Capital Securities are listed on the New Zealand Debt Market ("NZDX").

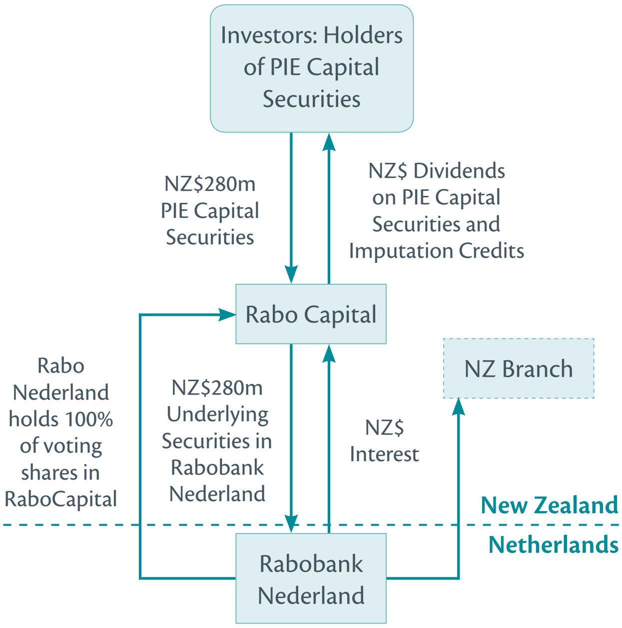
Rabo Capital used the funds raised from the issue of the PIE Capital Securities to invest in capital securities issued by Rabobank Nederland ("Underlying Securities") on or about the issue date of the PIE Capital Securities. Rabobank Nederland uses these funds for its banking business.

The Board of Directors of Rabo Capital and/or the Supervisory Board of Rabobank Nederland have no intention that Rabo Capital and/or Rabobank Nederland promote the acquisition of PIE Capital Securities by providing holders of PIE Capital Securities or prospective holders with a loan or other financing from any of the companies in the Rabo Capital or Rabobank Nederland Group.

This Ruling does not apply to any holder of PIE Capital Securities who or which has funded the acquisition of PIE Capital Securities by means of borrowing or other financing from any of the companies in the Rabobank group of companies, where such borrowing or other financing was part of an express agreement or arrangement (whether in writing or otherwise) with such company that the proceeds of some or all of such borrowing or other financing would be used for the purposes of acquiring PIE Capital Securities.

1. Parties to the Arrangement are:
   - Rabobank Nederland, a co-operative entity incorporated under Dutch law and tax resident in the Netherlands;
   - Rabo Capital, a limited liability company incorporated under New Zealand law which is a wholly-owned subsidiary of Rabobank Nederland; and
   - Holders of PIE Capital Securities ("the **Holders**").
2. The transactions comprising the Arrangement are governed by documents that were provided to Inland Revenue on 2 April, 22 April or 24 April 2009. The documents are:
   - Agency Agreement between Rabo Capital, Rabobank Nederland and Computershare Investor Services Limited ("Registrar") dated 16 April 2009 ("Agency Agreement");
   - Terms and Conditions of the Underlying Securities set out in Exhibit A of the Agency Agreement;
   - Constitution of Rabo Capital registered with the New Zealand Companies Office on 27 April 2009 ("the Constitution");
   - Terms and Conditions of the PIE Capital Securities attached as the Appendix to the Constitution ("PIE Conditions");
   - Investment Statement for the purposes of the Securities Act 1987 for the offer of PIE Capital Securities, dated 17 April 2009 ("the Investment Statement");
   - NZX Regulation Decision dated 17 April 2009; and
   - Listing Agreement NZDX Market between Rabo Capital and NZX Limited ("NZX").

3. The Arrangement is summarised in the diagram below and discussed in subsequent paragraphs:



4. The PIE Capital Securities and the Underlying Securities will constitute Tier 1 Capital of the Rabobank Group (comprising Rabobank Nederland together with its branches, consolidated subsidiaries and local member banks, including Rabo Capital) for the purposes of the Dutch Central Bank, which is the home prudential authority for Rabobank Nederland.

Rabo Capital

Incorporation of Rabo Capital

5. Rabo Capital is a special purpose company incorporated on 15 April 2009 under the Companies Act 1993 with 1000 $1 ordinary shares, all of which are held by Rabobank Nederland. Rabobank Nederland is a co-operative entity incorporated under Dutch law and tax resident in the Netherlands.

6. The ordinary shares carry all the voting rights in Rabo Capital but the holder of the ordinary shares is not, by virtue of that holding, entitled to participate in any dividend or distribution (including by way of a return of capital) made by Rabo Capital.

Rabo Capital Constitution

7. Rabo Capital has no power to carry on any business or activity other than that described in the Constitution.

8. Clause 5.1 of the Constitution states:

> **5.1 Limitation on Business:** The only business or activity which the Company may carry on is to:
>
> (a) issue and maintain in existence PIE Capital Securities, including listing (and maintaining a listing of) those shares on any stock or securities exchange in New Zealand or elsewhere;
>
> (b) use the proceeds of PIE Capital Securities to subscribe for perpetual Tier 1 bonds issued by Rabobank Nederland, or a related company of Rabobank Nederland;
>
> (c) enter into the Agency Agreement and the Security Trust Deed (and any other administration agreements, security trust deeds, registration agreements and/or deed polls in connection with the issue of PIE Capital Securities); and
>
> (d) do all other things reasonably incidental to the activities referred to in sub-paragraphs (a), (b), (c) above and this Constitution.
>
> The Company has no power to:
>
> (e) carry on any other business or activity; or
>
> (f) apply amounts received by way of interest on, or repayment of, the bonds referred to in sub-paragraph (b) above for any purpose other than in payments to Holders, meeting costs and expenses incurred in connection with the issuance and maintenance in existence of PIE Capital Securities and making income and other tax payments to the New Zealand Inland Revenue Department.

9. Rabo Capital constitutes a "listed PIE" under the "portfolio investment entity" ("PIE") regime. Rabo Capital elected into the PIE regime on 22 April 2009, with a commencement date of 27 May 2009.

10. Under the Constitution, Rabo Capital may take all steps it considers necessary or desirable to ensure it continues to be eligible as a PIE and a listed PIE or otherwise to comply with the requirements of the Act relating to PIEs. These requirements include (but are not limited to):

- refusing to register the transfer of any PIE Capital Securities;
- treating the transfer of any PIE Capital Securities as void (*ab initio* or from such other date as Rabo Capital may decide in its complete discretion) (clause 3(i)(ii) of the PIE Conditions);
- deeming any PIE Capital Securities held that would result in any holder (or where the holder is a nominee their beneficial owner) exceeding the maximum holding that an investor may hold in Rabo Capital in order for it to meet the PIE eligibility requirements in the Act, to be held by the holder of the PIE Capital Securities on trust for any member of the Rabobank Group appointed by Rabo Capital and allowing such member full powers of direction in relation to those PIE Capital Securities, including when, how and to whom they may be transferred (clause 3(i)(ii) of the PIE Conditions);
- allowing Rabo Capital or the Registrar to request any holder (or any person associated with that holder)

of PIE Capital Securities to provide such information or evidence as it may require to determine whether Rabo Capital is eligible or continues to be eligible as a PIE and qualify as a listed PIE and, where holders do not provide such information within specified time periods, deeming that such holder's (or where the holder is a nominee, such beneficial owner's) PIE Capital Securities are held on trust for a member of the Rabobank Group appointed by Rabo Capital and such member of the Rabobank Group shall have full powers of direction in relation to those PIE Capital Securities including when, how and to whom they may be transferred (clauses 3(i)(iii) and (iv) of the PIE Conditions);

- allowing Rabo Capital or the Registrar to take any of the steps in clause 3(i)(v) of the PIE Conditions to ensure that any breach of the PIE regime "investor interest size" requirement is remedied within the period required by the Act.

PIE Capital Securities

11. Rabo Capital offered PIE Capital Securities with a face value of $1 each to the public in New Zealand for $1 per security. The minimum holding amount is $5,000. The offer which opened on 27 April 2009 and closed on 22 May 2009, was available to retail and institutional investors. Rabobank Nederland acquired 5,000 PIE Capital Securities on 5 February 2010.

12. On 25 May 2009 Rabo Capital accepted a total of $280 million in applications.

13. Rabo Capital has entered into a Listing Agreement with NZX for the PIE Capital Securities to be quoted on the NZDX (the debt security market operated by NZX). Although the PIE Capital Securities are not debt securities for the purposes of the Securities Act 1978, NZX Regulation has given certain rulings and waivers from the NZDX Listing Rules in relation to the listing of the PIE Capital Securities on the NZDX.

14. The PIE Capital Securities are perpetual non-cumulative non-voting preference shares of Rabo Capital and shall at all time rank *pari passu* and without any preference among themselves (clause 4(a) of the PIE Conditions). They are direct, unsecured and subordinated obligations of Rabo Capital and are not guaranteed by Rabobank Nederland or any other person.

15. Dividends are paid on the PIE Capital Securities quarterly in arrears on the "Initial Rate Dividend Payment Date", with the first dividend payment date occurred on 18 June 2009 (clause 5(c) of the PIE Conditions).

16. The dividend amount is the amount of cash payable to holders of PIE Capital Securities on the relevant dividend payment date. The dividend amount for each dividend period from 18 June 2009 to 18 June 2019 is calculated as follows:

$$\frac{\textit{face value} \times \textit{dividend rate} \times (1 - t)}{4}$$

Where "*t*" is the weighted basic rate of New Zealand corporate income tax expressed as a percentage applicable to Rabo Capital (currently 28 percent) during the period ending on the relevant dividend payment date.

The "*dividend rate*" used to calculate the dividend amount will be as follows:

a) for the first 10 years, the initial rate, which is equal to the sum of the margin and the benchmark rate (the five-year swap rate), which will be reset after five years; and

b) thereafter, the floating rate, which is equal to the sum of the margin and the three-month bank bill rate, which is reset quarterly.

17. The Investment Statement contains the following statement, relating to dividends payable on the PIE Capital Securities (at page 6):

> **Dividend:**
>
> The PIE Capital Securities will pay a non-cumulative dividend. Dividend Amounts are scheduled to be paid quarterly on each 18 March, 18 June, 18 September and 18 December. The Dividend Amount is the cash component of the dividend and is a proportion of the amount calculated using the Dividend Rate. Dividend Amounts payable on the PIE Capital Securities will be paid to the person registered as the Holder on the relevant Record Date (including in relation to the first Dividend Amount payable).
>
> **Initial Dividend Rate:**
>
> The initial Dividend Rate will be set for an initial period of approximately 5 years from the Issue Date to 18 June 2014 at the greater of:
>
> - the Minimum Initial Rate, which is 8% per annum; and
> - the Benchmark Rate on 25 May 2009 plus the Margin.
>
> **Dividend Rate reset:**
>
> The Dividend Rate will be reset for a further 5 years on 18 June 2014 at the prevailing Benchmark Rate plus the Margin. From 18 June 2019 the Dividend Rate will reset quarterly, at the 90 day bank bill rate plus the Margin.

18. On 25 May 2009 the dividend rate for the period until 18 June 2014, incorporating the margin (which has been set at 3.75 percent per annum) and the swap rate, was set at 8.7864 percent per annum.

19. On 19 June 2014 the dividend rate for the period until 17 June 2019, incorporating the margin (which has been set at 3.75% per annum) and the swap rate was set at 8.3425 percent per annum.

20. Rabo Capital attaches imputation credits to distributions made to holders of PIE Capital Securities to the maximum extent permitted by the imputation credits available. At the current corporate income tax rate of 28 percent, this would be a maximum of 28/72 of the dividend amount. The Investment Statement contains the following statement (at page 11)—note that the corporate tax rate was 30 percent in 2009:

> **Imputation Credits**
>
> The Issuer will attach imputation credits to Dividend Amounts to the extent permitted by the imputation credits that the directors of the Issuer determine are available. It is expected that dividends will have imputation credits fully attached to a Dividend Amount (30/70th of the Dividend Amount assuming a corporate tax rate of 30%). If the Issuer does not fully impute a Dividend Amount, this may trigger an Exchange Event and the PIE Capital Securities may, at the Issuer's option, exchange into the Underlying Securities issued by Rabobank Nederland or be redeemed. Alternatively, the Issuer may, at its discretion, put in place an arrangement to reimburse Holders who are adversely affected by the dividends not being fully imputed.

Underlying Securities

21. Rabo Capital used the funds raised from the issue of PIE Capital Securities to invest in Underlying Securities issued by Rabobank Nederland on or about the issue date of the PIE Capital Securities. The Underlying Securities are interest-bearing, unsecured, perpetual, non-cumulative subordinated bonds. The principal amount of the Underlying Securities is equal to the subscription amount of the PIE Capital Securities. The Underlying Securities will have terms conforming substantially to the terms of the PIE Capital Securities. However, the Underlying Securities constitute bonds paying interest rather than shares paying imputed dividends. The Underlying Securities will be the only material asset of Rabo Capital and at least 90 percent of the income Rabo Capital will derive from interest from its investment in the Underlying Securities.

22. Rabobank Nederland uses the funds raised from the issue of Underlying Securities for its banking business. The funds are not being raised specifically for the purposes of Rabobank Nederland's New Zealand branch ("NZ Branch"), although Rabobank Nederland may "on-lend" some of the funds raised to NZ Branch.

23. Interest received by Rabo Capital on the Underlying Securities will constitute assessable income for Rabo Capital.

24. Rabo Capital will receive credits in its imputation account for New Zealand tax paid.

Termination of Arrangement

25. The PIE Capital Securities are perpetual securities that have no scheduled repayment date, but the PIE Capital Securities will be redeemed in the following circumstances (among others). The circumstances are set out in clause 8 of the PIE Conditions and are:

    a) if Rabo Capital exercises the option contained in clause 8(c) of the PIE Conditions on the "First Call Date" which is specified as being 18 June 2019 or on any dividend payment date thereafter;

    b) if, as a result of a Netherlands tax law change, there is more than an insubstantial risk that additional amounts are payable under the Underlying Securities or interest payable on the Underlying Securities would not be deductible to Rabobank Nederland for Netherlands tax purposes and Rabo Capital elects to redeem the PIE Capital Securities;

    c) if the Dutch Central Bank notifies Rabo Capital that the PIE Capital Securities may not be included in consolidated Tier 1 Capital of the Rabobank Group and Rabo Capital elects to redeem the PIE Capital Securities;

    d) where the Underlying Securities are redeemed; or

    e) on the occurrence of certain "Exchange Events" the PIE Capital Securities may be, at the option of Rabo Capital either cancelled and exchanged for Underlying Securities with a face value equal to the face value of the PIE Capital Securities or redeemed. The types of circumstances that would constitute an "Exchange Event" are described in the "Definitions" section of the PIE Conditions and summarised in the Investment Statement as follows (at page 12):

> **Exchange Events**
>
> On the occurrence of certain events (each an "Exchange Event") the PIE Capital Securities may, at the option of the Issuer, exchange into the Underlying Securities issued by Rabobank Nederland or be redeemed. The Exchange Events are:
>
> (a) if the Dutch Central Bank requires that all PIE Capital Securities must be issued directly by Rabobank Nederland; or
>
> (b) an Insolvency Event in relation to the Issuer or Rabobank Nederland; or

(c) a default by the Issuer for more than 30 days in the payment of Dividend Amounts or Redemption Amounts (other than relating to an administrative error) in respect of any of the PIE Capital Securities; or

(d) any of the following events that the Issuer determines in its absolute discretion is an Exchange Event;

(i) an Increased Costs Event; or

(ii) any Tax Law Change which has or is expected to have the effect that the anticipated tax outcomes for the Issuer or for Holders as at the Issue Date are adversely affected (as determined by the Issuer); or

(iii) the Issuer does not impute a Dividend Amount at the maximum imputation ratio under the Tax Act and an arrangement is not in place, or in the Issuer's opinion is not expected to be in place, within 90 Business Days of the relevant Dividend Payment Date to fully reimburse Holders who are adversely affected; or

(iv) the New Zealand Inland Revenue Department has indicated that it will not provide or renew a satisfactory binding ruling or rulings (as determined by the Issuer) confirming the anticipated tax implications of the transaction for the Issuer and the Holders.

Upon the occurrence of an Exchange Event, Holders of the PIE Capital Securities may, at the option of the Issuer, receive Underlying Securities in a principal amount equal to the Redemption Amount of each Holder's PIE Capital Securities at the relevant time or have their PIE Capital Securities redeemed. Prior to the distribution to Holders of the Underlying Securities or redemption, any Outstanding Amounts and any surplus amounts (after accounting for the Outstanding Amounts and the distribution of the Underlying Securities) held by the Issuer will be paid out pro rata to Holders.

Administration Costs

26. Rabo Capital pays Rabobank Nederland an administration fee for administration services provided by Rabobank Nederland. The administration does exceed an arm's length amount.

27. The New Zealand branch of Rabobank Nederland ("NZ Branch") provided a liquidity facility to Rabo Capital pursuant to which Rabo Capital may request advances of up to NZ$10 million from NZ Branch. Any interest paid by Rabo Capital to NZ Branch pursuant to the liquidity facility will be on arm's length terms or, if not on arm's length terms, on terms that are in favour of Rabo Capital. It is expected that money from this funding facility will only be used to pay tax or other expenses of Rabo Capital if it has insufficient available funds before receiving income under the Underlying Securities. There is no intention on the part of the Board of Directors of Rabo Capital and/or the Supervisory Board of Rabobank Nederland that Rabo Capital, Rabobank Nederland and/or NZ Branch would be paid any of the income that should otherwise be paid to the holders of PIE Capital Securities.

Condition stipulated by the Commissioner

This Ruling is made subject to the following condition:

a) This Product Ruling will cease to apply if the Binding Private Ruling (BR Prv 14/38) issued in respect of the Rabo Capital PIE regime Arrangement no longer applies or Rabo Capital ceases to be eligible to be a PIE and a listed PIE.

How the Taxation Laws apply to the Applicants and the Arrangement

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

- Distributions or dividends made by Rabo Capital to Holders constitute excluded income of a New Zealand tax resident Holder who is a natural person or a trustee and who does not include the amount as income in their return of income for the income year, pursuant to section CX 56C(1) of the Act.
- Where section CX 56C(1) does not apply, distributions or dividends made by Rabo Capital to Holders under the PIE Capital Securities constitute excluded income of a Holder to the extent to which the amount of the distribution or dividend is more than the amount that is fully credited as described in section CD 43(26) of the Act.
- Section GB 35 (streaming) does not apply to the Arrangement.
- Section BG 1 and section GA 1 (tax avoidance) do not apply to the Arrangement.

The period or income year for which this Ruling applies

This Ruling will apply for the period beginning on 1 July 2014 and ending on 30 June 2019.

This Ruling is signed by me on the 25th day of August 2014.

John Trezise
Investigations Manager

EXTENSION OF PUBLIC RULING BR PUB 08/03: PROJECTS TO REDUCE EMISSIONS PROGRAMME – INCOME TAX TREATMENT

The following notice to extend Public Ruling BR Pub 08/03 was published in the *Gazette* of 23 October 2014:

Notice of Extension of Public Ruling

1. This is a notice of extension of a public ruling made under section 91DD of the Tax Administration Act 1994.
2. Public Ruling BR Pub 08/03 "Projects to reduce emissions programme – Income tax treatment" was signed on 7 November 2008 and was published in *Tax Information Bulletin* Vol 20, No 10 (December 2008).
3. Public Ruling BR Pub 08/03 originally applied for the period from 1 April 2008 to 31 December 2013. The ruling now applies for the period from 1 January 2014 until 31 December 2018.

Susan Price
Director, Public Rulings

Explanation

BR Pub 08/03 considered the income tax consequences of agreements entered into between the Crown and participants for the provision of emission units in exchange for the implementation of projects which would reduce carbon emissions. Those agreements expired on 31 December 2013.

BR Pub 08/03 considers the income tax consequences of the provision of emissions units to the participants, and the sale of those emissions units to third parties. As the agreements have now expired, the Crown will no longer be providing emissions units to participants. However, some of the participants still hold emissions units which they may sell to third parties.

Given the limited nature of the arrangement considered by BR Pub 08/03, and the limited number of people potentially affected, the Commissioner has decided not to re-issue this ruling. Instead, the Commissioner has decided to extend Public Ruling BR Pub 08/03 under section 91DD of the Tax Administration Act 1994.

DECISION NOT TO REISSUE PUBLIC RULING BR PUB 08/04: PROJECTS TO REDUCE EMISSIONS PROGRAMME – GST TREATMENT

BR Pub 08/04 "Projects to reduce emissions programme – GST treatment" (published in *Tax Information Bulletin* Vol 20, No 10 (December 2008)) applied from 1 January 2008 to 31 December 2013.

The ruling is specific to a programme run by the Ministry for the Environment between 2003 and 2013 linked to the Government's emissions reduction targets under the Kyoto Protocol. Under the Projects to Reduce Emissions (PRE) programme, the Crown contracted with various participants to provide emissions units in exchange for the implementation of projects anticipated to significantly reduce emissions. The ruling considered the GST consequences of supplies under these contracts.

The contracts entered into under the PRE programme terminated on 31 December 2013. The Ministry for the Environment has confirmed that all supplies under those contracts have now ceased. As a result, the Commissioner considers that BR Pub 08/04 is no longer relevant. Therefore, the Commissioner will not be re-issuing this ruling.

QUESTIONS WE'VE BEEN ASKED

This section of the *TIB* sets out the answers to some day-to-day questions people have asked. They are published here as they may be of general interest to readers.

QB 14/10: GST – WHETHER A BINDING CONTRACT ALWAYS ESTABLISHES A TRANSACTION GIVING RISE TO A SUPPLY FOR SECTION 9(1) PURPOSES

All legislative references are to the Goods and Services Tax Act 1985 unless otherwise stated.

This Question We've Been Asked is about s 9(1).

Question

1. We have been asked whether a binding contract always establishes a transaction giving rise to a supply for s 9(1) time of supply purposes.

Answer

2. Generally such a transaction can be assumed where there is a binding contract. However, in some circumstances, the requirements for a binding contract may be satisfied but the contract will not establish there is a transaction giving rise to a supply for s 9(1) purposes. This would be the case where the making of a supply is factually or legally impossible **from the outset** or **becomes** impossible **before** s 9(1) can apply to determine the time of supply, or where the contract is used to commit fraud with no intention of making a supply, or found to be void, a sham, or otherwise legally ineffective.
3. No GST consequences can attach in such circumstances. Therefore, any output tax accounted for or input tax credit claimed by the parties to the contract in such circumstances would be incorrect and would require amendment under ss 113 or 113A of the Tax Administration Act 1994 (TAA).
4. If the supply becomes factually or legally impossible to make **after** the time of supply has been triggered under s 9(1), the contract will establish a transaction giving rise to a supply for s 9(1) purposes. However, if the supply becomes factually or legally impossible to make after the time of supply under s 9(1) has been triggered, but during the same taxable period as the one in which s 9(1) was triggered, the supply cannot be attributable to that (or any other) taxable period. The supplier is therefore not required to account for output tax and the recipient is not entitled to claim an input tax credit. If however any output tax is in fact accounted for, or input tax credit claimed, by the parties to the contract in such circumstances, this would be incorrect and would require amendment under ss 113 or 113A of the TAA.
5. If the supply becomes factually or legally impossible to make in a taxable period after the one in which s 9(1) was triggered, the supplier remains obliged to account for output tax, and the recipient remains entitled to claim an input tax credit for that supply (subject to the matters discussed at para 38 below). In such circumstances, s 25 will be the appropriate section under which to make the necessary adjustments to reflect that the supply is no longer possible to make.
6. This QWBA applies from 30 September 2014.

Background

7. In 2010, the Commissioner published IS 10/03: "GST: Time of supply – payments of deposits, including to a stakeholder" in *Tax Information Bulletin* Vol 22, No 6 (July 2010): 7. IS 10/03 considered the application of the time of supply rule in s 9(1) to situations involving the payment of a deposit, including payment to a stakeholder.
8. IS 10/03 concluded that a transaction giving rise to a supply must be established before s 9(1) will apply. The item confirmed that s 9(1) is a timing-only provision; it will apply to fix the time of supply only if there is a transaction giving rise to a supply. The legal arrangements entered into between the parties must be considered to determine whether a transaction giving rise to a supply exists. IS 10/03 stated that where there is a binding contract such a transaction is assumed. Where there is no contract, the existence of a transaction giving rise to a supply will be established where there are reciprocal obligations between the parties.
9. Since the publication of IS 10/03, we have been asked whether it can always be assumed there is a transaction giving rise to a supply for s 9(1) purposes where there is a binding contract.
10. A transaction giving rise to a supply may be established in other ways, but the focus of this QWBA is on binding contracts.

Explanation

11. The issue for s 9(1) purposes is whether there is a transaction giving rise to a supply, rather than whether there is a contract. The legal rights and obligations entered into by the parties must be established in the light of the factual background to the transaction to determine whether there is a supply and the nature of the supply: *Wilson & Horton Ltd v CIR* (1995) 17 NZTC 12,325 (CA); *CIR v NZ Refining Co Ltd* (1997) 18 NZTC 13,187 (CA); *Chatham Islands Enterprise Trust v CIR* (1999) 19 NZTC 15,075 (CA); *CIR v Gulf Harbour Development Ltd* (2004) 21 NZTC 18,915 (CA); *Rotorua Regional Airport Ltd v CIR* (2010) 24 NZTC 23,979 (HC).

12. Section 9(1) defines the time of supply for the purpose of determining when output tax is payable or input tax is deductible: *Pine v CIR* (1998) 18 NZTC 13,570 (CA); *CIR v Capital Enterprises Ltd* (2002) 20 NZTC 17,511 (HC). As stated, s 9(1) is a timing-only provision; it will apply to fix the time of supply only if there is a transaction giving rise to a supply.

13. The operation of s 9(1) is triggered when the supplier issues an invoice or receives any payment (whichever is earlier) in respect of a supply. Its operation does not depend on the actual making of a supply (in terms of goods provided or services performed) but on there being a transaction giving rise to a supply. While such a transaction is required in all cases for s 9(1) to apply, establishing a transaction giving rise to a supply will be particularly relevant when the supply has not yet been made at the time the supplier issues an invoice or receives any payment in respect of that supply.

14. Where the supply has not yet been made (in terms of goods provided or services performed), there will still usually be a transaction giving rise to a supply for s 9(1) purposes where a binding contract exists under which the supplier has an obligation to make a supply: *Case L67* (1989) 11 NZTC 1,391; *Case N24* (1991) 13 NZTC 3,199; *Rob Mitchell Builder Ltd (in liquidation) v National Bank of New Zealand Ltd* (2004) 21 NZTC 18,397 (CA); *Nigel Mansell Sports Co Ltd* [1991] BVC 718. This is because a binding contract generally establishes there is a transaction giving rise to a supply for s 9(1) purposes. A binding contract is one where the requirements of a contract are satisfied.

15. However, in some circumstances, a binding contract may not establish a transaction giving rise to a supply. In other circumstances, a written document that appears to be a binding contract may not, in fact, be a binding contract when considered in the light of the factual background. Such a document will also not establish a transaction giving rise to a supply.

When does a binding contract not establish a transaction giving rise to a supply?

16. This question will be answered by first considering the situation where the making of a supply is factually or legally impossible from the outset. This QWBA will then consider situations where the making of a supply becomes factually or legally impossible. Finally, contracts used to commit fraud, sham and other legally ineffective contracts will be considered.

The making of the supply is factually or legally impossible from the outset

No binding contract

17. Whether there is a binding contract (ie, offer and acceptance, an intention to be bound and certainty as to the essential terms of the contract) is judged objectively: *Wilmott v Johnson* [2003] 1 NZLR 649 (CA); *Mechenex Pacific Services Ltd v TCA Airconditioning (New Zealand) Ltd* [1991] 2 NZLR 393 (CA).

18. While it is theoretically possible to enter into a contract to do something that is impossible (*Jones v St John's College* (1870) LR 6 QB 115; *Eurico S.p.A. v Philipp Brothers* [1987] 2 Lloyd's Law Reports 215 (EWCACiv)), a binding contract will generally not arise in such instances.

19. A binding contract will not arise where an agreement is made to do something that is factually or legally impossible if the parties did not intend to be bound or consideration is not provided, or if the contract is void on the grounds of a common mistake of the parties: *Halsbury's Laws of England* (4th ed, Butterworth & Co (Publishers) Ltd, London, 1974) vol 9 at [447]; HG Beale (ed), *Chitty on Contracts* (30th ed, Thomson Reuters (Legal) Ltd, London, 2008) vol 1 at [3-023]; *Bell v Lever* [1932] AC 161 (HL). In such circumstances, a transaction giving rise to a supply for the purposes of s 9(1) will not be established.

20. *Case Z16* (2009) 24 NZTC 14,179 involved a contract for a supply that was legally impossible to make as the mortgagee did not have the right to exercise the power of sale. The High Court had previously, in separate litigation proceedings, found that the contract was void. *Case Z16* confirms that a contract that is void because the supplier does not hold, and is not able to obtain, legal rights that would enable a supply to be made, does not establish a transaction giving rise to a supply for s 9(1) purposes. If this situation exists at the time of supply under s 9(1), there will be no contract establishing a transaction giving rise to a supply.

Binding contract does not establish a transaction giving rise to a supply

21. It might be thought that the mere existence of a binding contract establishes a transaction giving rise to a supply, despite the supply contracted for being factually and legally impossible to make from the outset. However, as stated above, the issue is not whether there is a binding contract, but whether there is a transaction giving rise to a supply.

22. The mere existence of a binding contract for a supply that is factually or legally impossible to make from the outset will not establish a transaction giving rise to a supply for s 9(1) purposes, because:

    - In circumstances where the supply is factually or legally impossible to make from the outset, it will be clear that the supply contracted for will not be made. In such circumstances, there will be a sufficiently serious breach on the part of the supplier that would entitle the recipient to cancel the contract: ss 7(3) and 7(4) of the Contractual Remedies Act 1979. Where the supply is factually or legally impossible to make from the outset, the recipient does not have to proceed to cancel the contract before it will fail to establish a transaction giving rise to a supply for s 9(1) purposes (see the discussion of *Ch'elle Properties (NZ) Ltd v CIR* (2004) 21 NZTC 18,618 (HC) below). Therefore, a contract that the recipient is entitled to cancel because the supply is factually or legally impossible to make from the outset will not establish a transaction giving rise to a supply for s 9(1) purposes.
    - A supplier cannot be required to make a supply that is factually or legally impossible. A court will not enforce the performance of an obligation under a contract to make a supply that is factually or legally impossible: *Ferguson v Wilson* (1866) LR 2 Ch App 77; *Forrer v Nash* (1865) 35 Beav 167 (RollsCt); *Hall v Vernon* 34 SE 764 (W. Va. Dec 02, 1899); *Great Peace Shipping Ltd v Tsavliris Salvage International Ltd* [2002] 4 All ER 689 (EWCACiv); *Boyarsky v Taylor* [2008] NSWSC 1415. This is the case even if the reason for the impossibility is the fault of the defendant: *Seawell v Webster* (1859) 29 LJ Ch 71. A contract for a supply that neither party has an obligation to complete will not establish a transaction giving rise to a supply for s 9(1) purposes.

23. In summary, a binding contract will generally not arise where an agreement is made to do something that is factually or legally impossible from the outset, and a transaction giving rise to a supply for s 9(1) purposes will not be established. Even if there is a binding contract, the mere existence of the binding contract will not establish a transaction giving rise to a supply for s 9(1) purposes where the supply is factually or legally impossible to make from the outset.

The making of the supply becomes factually or legally impossible

24. The previous paragraphs considered whether a binding contract establishes a transaction giving rise to a supply where the supply is factually or legally impossible to make **from the outset**. This section considers whether a binding contract for a supply that **becomes** factually or legally impossible to make will establish a transaction giving rise to a supply. The answer depends on the time at which the supply becomes factually or legally impossible to make. If the contract is for a supply that becomes factually or legally impossible to make after the time of supply has been triggered under s 9(1), the contract will establish a transaction giving rise to a supply for s 9(1) purposes. Where the supply becomes factually or legally impossible to make before s 9(1) can apply to determine the time of supply, the contract will not establish a transaction giving rise to a supply.

25. An example of a supply that could potentially become factually or legally impossible to make is one where, at the time the agreement was entered into, a supplier did not own the goods agreed to be supplied or the goods agreed to be supplied did not exist. However, the mere fact that goods did not exist or that the supplier did not own goods at the time a contract was entered into, or at the time the supplier issued an invoice or received any payment, does not mean there cannot be a supply for s 9(1) purposes. A possibility may exist that a contract for a supply will not be performed, but this does not automatically mean that no supply will take place for GST purposes. Generally, parties to a contract cannot anticipate that the supply contracted for will not be made: *Case N24; Rob Mitchell; Bethway & Moss Ltd* (1988) 8 BVC 718. Therefore, such a contract for a supply will generally establish a transaction giving rise to a supply. However, where the making of the supply becomes factually or legally impossible before s 9(1) can apply to determine the time of supply, the contract will not establish a transaction giving rise to a supply.

26. Another example of a supply that becomes factually or legally impossible to make is one where (without default by either party) an event happens after a

contract is made that renders the supply in its entirety impossible to make and the contract does not provide for what is to happen if such an event occurs. In this situation the contract would terminate automatically: *National Carriers Ltd v Panalpina (Northern) Ltd* [1981] 1 All ER 161 (HL). If this situation exists before s 9(1) can apply to determine the time of supply, the contract will not establish a transaction giving rise to a supply. However, if the supply becomes factually or legally impossible to make after the time of supply has already been triggered under s 9(1), the contract will establish a transaction giving rise to a supply for s 9(1) purposes.

27. In *Ch'elle Properties*, certain vendor companies entered into agreements to purchase sections in a subdivision. They then on-sold these sections to Ch'elle Properties (NZ) Ltd (Ch'elle), who claimed input tax credits. It subsequently transpired that the agreements between the vendor companies and the original vendor were cancelled because the vendor companies had failed to settle on the stipulated date. The on-sale agreements between Ch'elle and the vendor companies were never cancelled. Ch'elle argued that, because the contracts between Ch'elle and the vendor companies had not been cancelled, the "supply" giving rise to the claims for input tax credits had not been altered under s 25 and that it therefore remained entitled to the input tax credits claimed. The court, however, disagreed with this submission. Rodney Hanson J concluded that the basis on which the supply had originally taken place had been utterly changed when the vendor companies lost the legal right to acquire the land they were on-selling as a result of the cancellation of the agreements with the original vendor. This was so despite the contracts between Ch'elle and the vendor companies not being cancelled.

28. The Commissioner considers the reason for the court's conclusion was that the supply had become impossible to make. The fact that the contracts between Ch'elle and the vendor companies remained on foot did not establish that a transaction giving rise to a supply existed.

29. In summary, a binding contract for a supply that becomes factually or legally impossible to make after the time of supply has been triggered under s 9(1) will establish a transaction giving rise to a supply for s 9(1) purposes. Where the supply becomes factually or legally impossible to make before s 9(1) can apply to determine the time of supply, the contract will not establish a transaction giving rise to a supply.

Contracts used to commit fraud, sham and other legally ineffective contracts

30. Where a contract is used as the means of committing a fraud and the purported supplier does not ever intend to make a supply, the contract will not establish a transaction giving rise to a supply for s 9(1) purposes: *Munn v C & E Commrs* [1989] VATTR 11; *C & E Commrs v Pennystar Ltd* (1996) BVC 125 (QBD).

31. A contract that is a sham or otherwise legally ineffective is not a binding contract and will not establish a transaction giving rise to a supply: *Marac Life Assurance Ltd v CIR* (1986) 8 NZTC 5,086 (CA); *Howard* (1981) 1 BVC 1,155. For more information about the meaning of sham and other issues relating to shams, see the Commissioner's interpretation guideline IG 12/01: "Goods and services tax; income tax – 'sham'" published in *Tax Information Bulletin* Vol 24, No 7 (August 2012): 3.

32. In summary, a contract used to commit fraud with no intention of making a supply, a sham or other legally ineffective contract will not establish a transaction giving rise to a supply for s 9(1) purposes.

How is a binding contract that does not establish a transaction giving rise to a supply treated for GST?

33. This QWBA is concerned with whether it can always be assumed there is a transaction giving rise to a supply for s 9(1) purposes where there is a binding contract. Practically, the time at which this will be most relevant is when GST is accounted for or claimed.

34. This QWBA has explained that a contract will not establish a transaction giving rise to a supply for s 9(1) purposes where the contract is:
    - for a supply that is factually or legally impossible to make from the outset;
    - for a supply that has become factually or legally impossible to make before s 9(1) can apply to determine the time of supply; or
    - used to commit fraud with no intention of making a supply, void, a sham or otherwise legally ineffective.

35. Section 9(1) cannot operate where the contract does not establish a transaction giving rise to a supply because there will be no supply for s 9(1) purposes. This means that any invoice issued or payment received by the supplier cannot trigger the operation of s 9(1) because the invoice is not issued, nor is payment received, "in respect of that supply", as is required for the operation of s 9(1). Also, any purported invoice will not meet the definition of "invoice" under s 2 because, where there is no supply, the document

cannot notify the recipient of an obligation to make payment. The supplier is not obliged to account for output tax, and the recipient is not entitled to claim input tax in this situation. Therefore, any output tax returned or input tax credit claimed by the parties to the contract in such circumstances would be incorrect and would require amendment under ss 113 or 113A of the TAA. (Section 113A of the TAA enables a taxpayer to correct certain minor errors in the return for the next taxable period.)

How is a binding contract for a supply that becomes factually or legally impossible to make after the time of supply has been triggered under s 9(1) treated for GST?

36. If the contract is for a supply that becomes factually or legally impossible to make after the time of supply has been triggered under s 9(1), the contract will establish a transaction giving rise to a supply for s 9(1) purposes. However, if the supply becomes factually or legally impossible to make after the time of supply under s 9(1) has been triggered, but during the same taxable period as the one in which s 9(1) was triggered, no supply can be attributed to that (or any other) taxable period under s 20. (Section 20 requires a person to calculate the amount of tax payable in respect of each taxable period by deducting input tax in relation to supplies made to that person during that taxable period from the amount of output tax attributable to the taxable period.) As no supply can be attributed to any taxable period, the supplier is not required to account for output tax and the recipient is not entitled to claim an input tax credit. Therefore, any output tax accounted for or input tax credit claimed by the parties to the contract in such circumstances would be incorrect and would require amendment under ss 113 or 113A of the TAA.

37. If the supply becomes factually or legally impossible to make in a taxable period **after** the one in which s 9(1) was triggered, the supply remains attributable to the taxable period in which s 9(1) was triggered. The supplier is therefore obliged to account for output tax, and the recipient is entitled to claim an input tax credit for that supply. Section 25 will then apply to reverse the GST consequences in the taxable period during which it becomes apparent that the output tax returned or input tax claimed is incorrect. The supplier will also be required, under s 25(3), to issue a credit note where the supplier has issued a tax invoice for that supply.

38. However, it must be noted that:

- Any refund claim made is subject to the Commissioner's right to withhold payment of a GST refund under s 46 where the Commissioner investigates the circumstances of the return, or requests further information concerning the return. This is provided the Commissioner notifies the taxpayer of her intention to investigate, or requests further information, within 15 days of receipt of the return.
- If, before the refund is paid out, it comes to the Commissioner's attention that the contract cannot proceed and a supply will not be made, the Commissioner is not required to ignore that fact and pay out the refund (subject to the Commissioner's obligation to act in accordance with s 46 as set out above and ss 89B and 89C of the TAA). This is because any refund paid out would be immediately recoverable: *Case X12* (2005) 22 NZTC 12,189 and *Riccarton Construction Ltd v CIR* (2010) 24 NZTC 24,191 (HC).

39. The Commissioner's view in Question We've Been Asked: "GST consequences of a cancelled contract" published in *Tax information Bulletin* Vol 17, No 4 (May 2005): 26 (the 2005 QWBA) could be interpreted as being inconsistent with the view expressed in this QWBA. The 2005 QWBA states that where a contract for the sale and purchase of land is cancelled after the time of supply under s 9(1) has been triggered, the supplier remains obliged to account for GST on the sale of that land and the recipient remains entitled to an input tax credit on the purchase of the land. This QWBA expresses the view that if the supply becomes factually or legally impossible to make after the time of supply under s 9(1) has been triggered, but during the same taxable period as the one in which s 9(1) was triggered, the supply cannot be attributable to that (or any other) taxable period. The supplier is therefore not required to account for output tax and the recipient is not entitled to claim an input tax credit. To the extent that the 2005 QWBA could be interpreted as being inconsistent with the view expressed in this QWBA, this QWBA should be relied on as representing the Commissioner's view.

Examples

40. The following examples assume transactions between registered persons in the course of carrying on taxable activities.

Example 1: Auckland Harbour Bridge

41. Two individuals enter into an agreement for the sale and purchase of the Auckland Harbour Bridge. An invoice is issued, but no payment is due until settlement in 50 years.

42. A transaction giving rise to a supply has not been established. This is because the factual background suggests any supposed contract did not create genuine legal rights and obligations. As it is general knowledge that the Bridge is in public ownership, is part of the State highway network and is unlikely to be offered for sale, it is unlikely the parties intended to be bound to make a supply that is impossible.

43. Even if there is a binding contract, the contract would not establish a transaction giving rise to a supply. As the vendor does not hold legal rights and would be unable to obtain legal rights that would enable the supply to be performed, the vendor could not be required to supply the Bridge. The purchaser would be entitled to cancel the contract. The existence of a contract under which the parties do not have reciprocal obligations involving a supply in return for payment will not establish a transaction giving rise to a supply for the purposes of s 9(1).

44. In this example an invoice can neither be issued "in respect of that supply", as is required for the operation of s 9(1), nor can it meet the s 2 definition of "invoice". This means that the issue of a purported invoice cannot trigger the operation of s 9(1). The vendor is not obliged to account for output tax and the purchaser is not entitled to claim an input tax credit. Should the parties incorrectly either account for output tax or claim an input tax credit in such circumstances, the assessment would require amendment under s 113 of the TAA.

Example 2: Movie car

45. A dealer enters into contracts for the purchase and on-sale of a unique car used in a famous movie. Invoices are issued and deposits paid under each contract. At the time the contracts were entered into, unbeknown to the parties, the car had been destroyed by fire and neither of the contracts provided for what was to happen if the car could not be supplied. As a result, the contracts are void on the grounds of a common mistake.

46. In this example, neither of the contracts establishes a transaction giving rise to a supply for the purposes of s 9(1). A supply is not treated as having taken place. The issue of the purported invoices cannot trigger the operation of s 9(1) because, in these circumstances, an invoice can neither be issued "in respect of that supply", as is required for the operation of s 9(1), nor can it meet the s 2 definition of "invoice". Similarly, the deposit payments cannot be made "in respect of that supply", as is required for the operation of s 9(1). Therefore, the dealer would not be entitled to an input tax credit on the purchase of the car and would not be required to account for output tax on the sale of the car. Should the dealer either account for output tax or claim an input tax credit, the assessment would require amendment under s 113.

Example 3: Copyright issues

47. Company A grants a licence to use a patent to Company B, believing it has the right to do so. Company A issues an invoice and Company B claims an input tax credit on the purchase of the licence resulting in a GST refund. It later transpires that Company A never in fact held any rights in the patent and is unable to obtain rights, so no rights could be licenced to Company B. As it is clear that the making of the supply is impossible, neither party can be held to the contract.

48. Therefore, the contract does not establish a transaction giving rise to a supply for the purposes of section 9(1). In this example the invoice can neither be made "in respect of that supply", as is required for the operation of s 9(1), nor can it meet the s 2 definition of "invoice". This means that the issue of the purported invoice by Company A cannot trigger the operation of s 9(1). Therefore, Company A is not obliged to account for output tax and Company B was not entitled to an input tax credit (even if the invoice complied with all the requirements for a tax invoice under s 24).

49. As Company B was not entitled to claim an input tax credit, the refund has been incorrectly obtained and requires amendment under s 113 of the TAA.

Example 4: Delayed delivery

50. A registered person enters into an agreement to purchase a number of computers and related PC hardware from Ned's PC Supplies. The terms of the agreement are that Ned's PC Supplies will order the computer equipment from its supplier and will invoice the registered person upon receipt of the equipment at its warehouse. Delivery of the equipment to the purchaser is to take place on an agreed date, with payment of the full purchase price to be made on delivery. An implied term of the contract is that Ned's PC Supplies will be able to supply the equipment and it is factually and legally possible to make the supply. Ned's PC Supplies experiences delays in obtaining the equipment and is unable to supply the equipment on the delivery date, so the purchaser decides not to go ahead with the purchase.

51. In this situation, there was a contract under which Ned's PC Supplies had a genuine legal obligation to supply the equipment. As a result of events that occurred after the contract was made, Ned's PC Supplies was unable to supply the equipment on time. The purchaser therefore had the right to, and did, cancel the contract. Since Ned's PC Supplies' breach of the contract occurred before the time of supply (because Ned's PC Supplies had neither issued an invoice yet, nor had it received any payment for the equipment) the contract fails to establish a transaction giving rise to a supply for the purposes of s 9(1).

52. Ned's PC Supplies is not obliged to account for output tax and the purchaser is not entitled to claim an input tax credit. However, should the parties mistakenly either account for output tax or claim an input tax credit in such circumstances, the assessment would require amendment under s 113 of the TAA or under s 113A of the TAA.

Example 5: Shipping disaster

53. A registered person enters into a contract with a car dealer to buy a new car and pays a deposit. The car dealer issues a tax invoice and accounts for and pays GST on the sale of the car. The purchaser claims an input tax credit on the purchase of the car resulting in a GST refund. The car needs to be shipped to New Zealand from Japan. The car falls off the boat in rough seas on the way to New Zealand. When it becomes clear that the car has been lost at sea and will not be provided to the purchaser, the dealer notifies the purchaser and refunds the deposit to the purchaser at the same time.

54. In this example, there were genuine contractual obligations for the supply of the car at the time of supply (being the earlier of the time the deposit was paid or the tax invoice issued). Therefore, the contract establishes a transaction giving rise to a supply for the purposes of s 9(1). As it became factually impossible to make the supply after the s 9(1) time of supply, s 25 would apply to adjust the car dealer's GST liability in the taxable period during which it has become apparent that the car will not be supplied. The car dealer would also be required to issue a credit note to the purchaser under s 25(3).

55. Section 25 would similarly apply to reverse the refund obtained by the purchaser in the taxable period in which the dealer notified the purchaser that the car had been lost at sea.

56. However, note that if, before the refund is paid out, it comes to the Commissioner's attention that the contract cannot proceed and the supply will not be performed, the Commissioner is not required to ignore that fact and pay out the refund.

References

Related rulings/statements
"GST consequences of a cancelled contract" *Tax Information Bulletin* Vol 17, No 4 (May 2005): 26
IS 10/03: "GST: Time of supply – payments of deposits, including to a stakeholder" *Tax Information Bulletin* Vol 22, No 6 (July 2010): 7
IG 12/01: "Goods and services tax; income tax – 'sham'" *Tax Information Bulletin* Vol 24, No 7 (August 2012): 3
Subject references
GST; Supply; Time of supply
Legislative references
Contractual Remedies Act 1979 – ss 7(3)(c), 7(4)
Goods and Services Tax Act 1985 – ss 9(1), 25, 46
Tax Administration Act 1994 – ss 89B, 89C, 113, 113A
Case references
Bell v Lever [1932] AC 161 (HL)
Bethway & Moss Ltd (1988) 8 BVC 718
Boyarsky v Taylor [2008] NSWSC 1415
C & E Commrs v Pennystar Ltd (1996) BVC 125 (QBD)
Case L67 (1989) 11 NZTC 1,391
Case N24 (1991) 13 NZTC 3,199
Case X12 (2005) 22 NZTC 12,189
Case Z16 (2009) 24 NZTC 14,179
Chatham Islands Enterprise Trust v CIR (1999) 19 NZTC 15,075 (CA)
Ch'elle Properties (NZ) Ltd v CIR (2004) 21 NZTC 18,618 (HC)
CIR v Capital Enterprises Ltd (2002) 20 NZTC 17,511 (HC)
CIR v Gulf Harbour Development Ltd (2004) 21 NZTC 18,915 (CA)
CIR v NZ Refining Co Ltd (1997) 18 NZTC 13,187 (CA)
Eurico S.p.A. v Philipp Brothers [1987] 2 Lloyds Law Reports 215 (EWCACiv)
Ferguson v Wilson (1866) LR 2 Ch App 77
Forrer v Nash (1865) 35 Beav 167 (RollsCt)
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Marac Life Assurance Ltd v CIR (1986) 8 NZTC 5,086 (CA)
Mechenex Pacific Services Ltd v TCA Airconditioning (New Zealand) Ltd [1991] 2 NZLR 393 (CA)
Munn v C & E Commrs [1989] VATTR 11
National Carriers Ltd v Panalpina (Northern) Ltd [1981] 1 All ER 161 (HL)
Nigel Mansell Sports Co Ltd [1991] BVC 718
Pine v CIR (1998) 18 NZTC 13,570 (CA)
Riccarton Construction Ltd v CIR (2010) 24 NZTC 24,191 (HC)
Rob Mitchell Builder Ltd (in liquidation) v National Bank of New Zealand Ltd (2004) 21 NZTC 18,397 (CA)
Rotorua Regional Airport Ltd v CIR (2010) 24 NZTC 23,979 (HC)
Seawell v Webster (1859) 29 LJ Ch 71
Wilmott v Johnson [2003] 1 NZLR 649 (CA)
Wilson & Horton Ltd v CIR (1995) 17 NZTC 12,325 (CA)

LEGISLATION AND DETERMINATIONS

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

FOREIGN CURRENCY AMOUNTS – CONVERSION TO NEW ZEALAND DOLLARS

This article provides the exchange rates acceptable to Inland Revenue for converting foreign currency amounts to New Zealand dollars under the controlled foreign company (CFC) and foreign investment fund (FIF) rules for the six months ending 30 September 2014.

The Income Tax Act 2007 ("2007 Act") requires foreign currency amounts to be converted into New Zealand dollars applying one of the following methods:

- actual rate for the day for each transaction (including close of trading spot exchange rate on the day), or
- rolling 12-month average rate for a 12-month accounting period or income year (see the table **Currency rates 6 months ending 30 September 2014 – rolling 12-month average**), or
- mid-month actual rate as the basis of the rolling average for accounting periods or income years greater or lesser than 12 months (see the table **Currency rates 6 months ending 30 September 2014 – mid-month actual**).

Legislation enacted in September 2010 with effect from 1 April 2008 permits the Commissioner to set currency rates and approve methods of calculating exchange rates. The Commissioner can set rates for general use by taxpayers or for specific taxpayers. The Commissioner's ability to set rates and approve methods applies in circumstances where the 2007 Act does not contain a specific currency conversion rule (sections YF 1(5) and (6)), or in circumstances where the 2007 Act provides a rate or method for currency conversion (section YF 2).

Inland Revenue uses wholesale rates from Bloomberg for rolling 12-month average, mid-month actual and end of month. These rates are provided in three tables.

You must apply the chosen conversion method to all interests for which you use the FIF or CFC calculation method in that and each later income year.

To convert foreign currency amounts to New Zealand dollars for any country listed, divide the foreign currency amount by the exchange rate shown. Round the exchange rate calculations to four decimal places wherever possible.

If you need an exchange rate for a country or a day not listed in the tables, please contact one of New Zealand's major trading banks.

Note: All section references relate to the 2007 Act.

Actual rate for the day for each transaction

The actual rate for the day for each transaction can be used in the following circumstances:

- where the 2007 Act does not provide a specific currency conversion rule, then foreign currency amounts can be converted by applying the close of trading spot exchange rate on the date the transaction is required to be measured or calculated (section YF 1(2))
- where a person chooses to use the actual rate for the day of the transaction when calculating their FIF income or loss by applying the comparative value method, fair dividend rate method, deemed rate of return method or the cost method (section EX 57(2)(a))
- where a person chooses to use the close of trading spot exchange rate to convert foreign income tax paid by a CFC (section LK 3(a)) or by a FIF where the attributable FIF income method is used (sections EX 50(8)–(9) and LK 3(a)).

Unless the actual rate is the rate for the 15th or the last day of the month, these rates are not supplied by Inland Revenue.

The table **Currency rates 6 months ending 30 September 2014 – month end** provides exchange rates for the last day of the month. These are provided for convenience to assist taxpayers who may need exchange rates on those days.

Currency rates 6 months ending 30 September 2014 – rolling 12-month average table

This table is the average of the mid-month exchange rate for that month and the previous 11 months, ie, the 12-month average. This table should be used where the accounting period or income year encompasses 12 complete months.

This table can be used to convert foreign currency amounts to New Zealand dollars for:

- FIF income or loss calculated under the comparative value method, the fair dividend rate method, the deemed rate of return method or cost method (section EX 57(2)(b)) for accounting periods of 12 months

- FIF income or loss calculated under the attributable FIF income method (section EX 50(3)(a)) for accounting periods of 12 months
- attributed CFC income or loss calculated under the CFC rules (section EX 21(4)(b)) for accounting periods of 12 months
- calculating the New Zealand dollar amount of foreign income tax under the CFC rules (section LK 3(b)) or under the FIF rules where the attributable FIF income method is used (sections EX 50(8)–(9) and LK 3(b)) for accounting periods of 12 months.

Currency rates 6 months ending 30 September 2014 – mid-month actual table

This table sets out the exchange rate on the 15th day of the month, or if no exchange rates were quoted on that day, on the preceding working day on which they were quoted. This table can be used as the basis of the rolling average where the accounting period or income year is less than or greater than 12 months (see Example 4). You can also use the rates from this table as the actual rate for any transactions arising on the 15th of the month.

This table can be used as the basis of the rolling average for calculating:

- FIF income or loss under the comparative value method, the fair dividend rate method, the deemed rate of return method or cost method (section EX 57(2)(b)) for accounting periods or income years of less than or greater than 12 months
- FIF income or loss calculated under the attributable FIF income method (section EX 50(3)(a)) for accounting periods of less than or greater than 12 months
- attributed CFC income or loss calculated under the CFC rules (section EX 21(4)(b)) for accounting periods of less than or greater than 12 months
- the New Zealand dollar amount of foreign income tax under the CFC rules (section LK 3(b)) or under the FIF rules where the attributable FIF income method is used (sections EX 50(8) & (9) and LK 3(b)) for accounting periods of less than or greater than 12 months.

Example 1

A taxpayer with a 30 September balance date purchases shares in a Philippine company (which is a FIF but does produce a guaranteed yield) on 6 September 2014. Its opening market value on 1 October 2014 or its closing market value on 30 September 2014 is PHP 350,000.

Using the comparative value method and applying the actual rate for the day (section EX 57(2)(a)), the opening market value is converted as follows:

PHP 350,000 ÷ 34.9056 = $10,027.04

(In this example, the rate selected is the month-end rate for September 2014 for PHP. Refer to the table "Currency rates 6 months ending 30 September 2014 – month end".)

Example 2

A CFC resident in Hong Kong has an accounting period ending on 30 June 2014. Attributed CFC income for the period 1 July 2013 to 30 June 2014 is 200,000 Hong Kong dollars (HKD), which converts to:

HKD 200,000 ÷ 6.4779 = $30,874.20

(In this example, the rate selected is the rolling 12-month average rate for June 2014 for HKD. Refer to the table "Currency rates 6 months ending September 2014 – rolling 12-month average".)

Example 3

A resident individual with a 30 September 2014 accounting period acquires a FIF interest in a Japanese company on 1 October 2013 for 10,500,000 yen. The interest is sold in September 2014 for 10,000,000 yen. Using the comparative value method and applying section EX 57(2)(b), these amounts are converted as:

JPY 10,500,000 ÷ 86.5238 = $121,353.89

JPY 10,000,000 ÷ 86.5238 = $115,575.14

(In this example, the rolling 12-month average rate for September 2014 for JPY has been applied to both calculations.)

Example 4

A CFC resident in Singapore was formed on 19 April 2014 and has a balance date of 30 September 2014. During the period 1 May 2014 to 30 September 2014, attributed CFC income of 500,000 Singaporean dollars was derived. For the conversion to New Zealand dollars the taxpayer chooses the method set out in section EX 21(4)(b).

1. Calculating the average monthly exchange rate for the complete months May–September 2014:

   1.0824 + 1.0838 + 1.0906 + 1.0569 + 1.0334 = 5.3471

   5.3471 ÷ 5 = 1.06942
2. Round exchange rate to four decimal places: 1.0694
3. Conversion to New Zealand currency:

   SGD 500,000 ÷ 1.0694 = $467,551.90

(In this example, the rates are from the table "Currency rates 6 months ending September 2014 – mid-month actual", from May to September 2014 inclusive for SGD.)

Currency rates 6 months ending 30 September 2014 – rolling 12-month average

Currency	Code	15/04/14	15/05/14	15/06/14	15/07/14	15/08/14	15/09/14
Australia Dollar	AUD	0.8930	0.9006	0.9074	0.9138	0.9161	0.9183
Bahrain Dinar	BHD	0.3118	0.3130	0.3150	0.3180	0.3193	0.3194
Britain Pound	GBH	0.5156	0.5134	0.5133	0.5129	0.5122	0.5115
Canada Dollar	CAD	0.8739	0.8826	0.8927	0.9035	0.9112	0.9164
China Yuan	CNY	5.0574	5.0840	5.1215	5.1757	5.1997	5.2036
Denmark Kroner	DKK	4.5759	4.5710	4.5946	4.6247	4.6422	4.6541
Eupopean Community Euro	EUR	0.6134	0.6127	0.6158	0.6198	0.6222	0.6239
Fiji Dollar	FJD	1.5345	1.5421	1.5523	1.5628	1.5666	1.5697
French Polynesia Franc	XPF	73.1962	73.1020	73.4776	73.9633	74.2513	74.4563
Hong Kong Dollar	HKD	6.4131	6.4384	6.4779	6.5394	6.5657	6.5684
India Rupee	INR	50.1807	50.7147	51.1440	51.6851	51.8590	51.7124
Indonesia Rupiah	IDR	9,143.4250	9,305.2317	9,494.1692	9,699.0142	9,823.0450	9,874.3592
Japan Yen	JPY	82.9923	83.2869	84.3350	85.2669	85.9535	86.5238
Korea Won	KOR	894.5172	891.9463	890.0198	892.1153	888.9103	886.0763
Kuwait Dinar	KWD	0.2342	0.2349	0.2363	0.2383	0.2392	0.2395
Malaysia Ringit	MYR	2.6570	2.6852	2.7085	2.7347	2.7368	2.7330
Norway Krone	NOK	4.9562	4.9832	5.0325	5.0918	5.1281	5.1619
Pakistan Rupee	PKR	84.7909	85.1383	85.6470	86.3830	86.5581	86.4384
Phillipines Peso	PHP	36.1448	36.4852	36.7735	37.1457	37.2813	37.3132
PNG Kina	PGK	1.9587	2.0095	2.0415	2.0801	2.1029	2.1151
Singapore Dollar	SGD	1.0396	1.0443	1.0507	1.0594	1.0622	1.0623
Solomon Islands Dollar*	SBD	0.1149	0.1152	0.1158	0.1167	0.1171	0.1170
South Africa Rand	ZAR	8.4352	8.5490	8.6532	8.7934	8.8705	8.9440
Sri Lanka Rupee	LKR	107.7314	108.5036	109.2758	110.2421	110.6361	110.5408
Sweden Krona	SEK	5.4025	5.4177	5.4668	5.5308	5.5763	5.6166
Swiss Franc	CHF	0.7546	0.7526	0.7557	0.7595	0.7610	0.7617
Taiwan Dollar	TAI	24.7306	24.8475	25.0115	25.2647	25.3691	25.4109
Thailand Baht	THB	26.1416	26.4405	26.7267	27.0501	27.2015	27.2422
Tonga Pa'anga*	TOP	1.4840	1.4969	1.5086	1.5217	1.5292	1.5354
United States Dollar	USD	0.8268	0.8301	0.8352	0.8432	0.8467	0.8470
Vanuatu Vatu	VUV	79.4444	79.6544	80.2284	80.9539	81.1127	81.0606
West Samoan Tala*	WST	1.9096	1.9148	1.9182	1.9415	1.9353	1.9253

Notes to table:

All currencies are expressed in NZD terms, ie, 1NZD per unit(s) of foreign currency.

The currencies marked with an asterisk * are not published on Bloomberg in NZD terms. However, these currencies are expressed in USD terms and therefore the equivalent NZD terms have been generated as a function of the foreign currency USD cross-rate converted to NZD terms at the NZDUSD rate provided.

The rates provided represent the Bloomberg generic rate (BGN) based on the last price (mid rate) at which the currency was traded at the close of the New York trading day. Where the date specified was not a trading day, then the rate reflects the last price on the preceding business day.

Source: Bloomberg CMPN BGN

Currency rates 6 months ending 30 September 2014 – mid-month actual

Currency	Code	15/04/14	15/05/14	15/06/14	15/07/14	15/08/14	15/09/14
Australia Dollar	AUD	0.9225	0.9238	0.9223	0.9358	0.9107	0.9056
Bahrain Dinar	BHD	0.3275	0.3258	0.3268	0.3306	0.3200	0.3083
Britain Pound	GBH	0.5194	0.5148	0.5111	0.5115	0.5083	0.5036
Canada Dollar	CAD	0.9526	0.9409	0.9405	0.9433	0.9246	0.9038
China Yuan	CNY	5.4025	5.3845	5.3840	5.4429	5.2234	5.0218
Denmark Kroner	DKK	4.6926	4.7062	4.7773	4.8187	4.7215	4.7040
Euporean Community Euro	EUR	0.6287	0.6305	0.6406	0.6461	0.6334	0.6318
Fiji Dollar	FJD	1.5865	1.5924	1.5936	1.6116	1.5691	1.5499
French Polynesia Franc	XPF	75.0305	75.2311	76.4640	77.1205	75.5956	75.3999
Hong Kong Dollar	HKD	6.7358	6.7001	6.7214	6.7953	6.5767	6.3375
India Rupee	INR	52.1834	51.3661	51.7090	52.9449	51.6762	49.9029
Indonesia Rupiah	IDR	9888.9800	9927.1300	10222.5800	10320.5600	9917.8900	9741.3100
Japan Yen	JPY	88.5450	87.7940	88.4140	89.1540	86.8510	87.6400
Korea Won	KOR	903.0903	889.4020	884.7852	900.8713	863.7851	848.9940
Kuwait Dinar	KWD	0.2444	0.2437	0.2448	0.2474	0.2404	0.2344
Malaysia Ringit	MYR	2.8106	2.7979	2.7893	2.8045	2.6784	2.6273
Norway Krone	NOK	5.1795	5.1432	5.1930	5.4446	5.2054	5.2274
Pakistan Rupee	PKR	83.3333	85.4701	85.4701	86.9565	84.7458	84.0336
Phillipines Peso	PHP	38.4626	37.8604	37.9504	38.3776	37.0934	36.0158
PNG Kina	PGK	2.3273	2.3688	2.1214	2.1479	2.0890	2.0196
Singapore Dollar	SGD	1.0886	1.0824	1.0838	1.0906	1.0569	1.0334
Solomon Islands Dollar*	SBD	0.1195	0.1184	0.1185	0.1207	0.1176	0.1116
South Africa Rand	ZAR	9.1316	8.9939	9.2571	9.3905	8.9920	8.9643
Sri Lanka Rupee	LKR	113.6364	112.3596	112.3596	113.6364	111.1111	106.3830
Sweden Krona	SEK	5.7007	5.6811	5.7621	5.9821	5.7994	5.8178
Swiss Franc	CHF	0.7646	0.7701	0.7798	0.7853	0.7658	0.7647
Taiwan Dollar	TAI	26.2545	26.1008	26.0062	26.3302	25.4387	24.6552
Thailand Baht	THB	28.0424	28.1120	28.0492	28.1804	27.0618	26.3860
Tonga Pa'anga*	TOP	1.5752	1.5827	1.5559	1.5714	1.5494	1.5333
United States Dollar	USD	0.8687	0.8643	0.8664	0.8768	0.8485	0.8176
Vanuatu Vatu	VUV	81.9672	80.6452	82.6446	83.3333	80.6452	78.7402
West Samoan Tala*	WST	1.9253	1.9241	1.9160	2.0981	1.8764	1.8448

Notes to table:

All currencies are expressed in NZD terms, ie, 1NZD per unit(s) of foreign currency.

The currencies marked with an asterisk * are not published on Bloomberg in NZD terms. However, these currencies are expressed in USD terms and therefore the equivalent NZD terms have been generated as a function of the foreign currency USD cross-rate converted to NZD terms at the NZDUSD rate provided.

The rates provided represent the Bloomberg generic rate (BGN) based on the last price (mid rate) at which the currency was traded at the close of the New York trading day. Where the date specified was not a trading day, then the rate reflects the last price on the preceding business day.

Source: Bloomberg CMPN BGN

Currency rates 6 months ending 30 September 2014 – month end

Currency	Code	30/04/14	31/05/14	30/06/14	31/07/14	31/08/14	30/09/14
Australia Dollar	AUD	0.9278	0.9126	0.9285	0.9145	0.8951	0.8927
Bahrain Dinar	BHD	0.3248	0.3205	0.3302	0.3205	0.3151	0.2944
Britain Pound	GBH	0.5107	0.5072	0.5120	0.5034	0.5037	0.4816
Canada Dollar	CAD	0.9446	0.9218	0.9345	0.9271	0.9096	0.8744
China Yuan	CNY	5.3941	5.3106	5.4340	5.2477	5.1396	4.7929
Denmark Kroner	DKK	4.6382	4.6524	4.7687	4.7331	4.7422	4.6019
Euporean Community Euro	EUR	0.6214	0.6235	0.6396	0.6348	0.6365	0.6182
Fiji Dollar	FJD	1.5921	1.5637	1.6057	1.5785	1.5492	1.5117
French Polynesia Franc	XPF	74.1179	74.4100	76.3285	75.7465	75.9102	73.7739
Hong Kong Dollar	HKD	6.6806	6.5879	6.7878	6.5878	6.4779	6.0630
India Rupee	INR	51.6389	50.1625	52.6042	51.4144	50.7197	47.8132
Indonesia Rupiah	IDR	9895.27	9915.52	10374.26	9830.26	9807.03	9460.30
Japan Yen	JPY	88.0770	86.4950	88.7410	87.3780	87.0400	85.6110
Korea Won	KOR	890.2261	868.0378	886.3065	877.7217	848.0726	826.5573
Kuwait Dinar	KWD	0.2422	0.2396	0.2466	0.2408	0.2380	0.2252
Malaysia Ringit	MYR	2.7949	2.7283	2.8049	2.7132	2.6441	2.5473
Norway Krone	NOK	5.1261	5.0765	5.3716	5.3431	5.1817	5.0163
Pakistan Rupee	PKR	84.7458	84.0336	86.2069	84.0336	85.4701	80.0000
Phillipines Peso	PHP	38.1535	37.1682	38.1353	36.9005	36.5698	34.9056
PNG Kina	PGK	2.3557	2.3328	2.1431	2.0846	2.0573	1.9411
Singapore Dollar	SGD	1.0803	1.0661	1.0917	1.0606	1.0441	0.9962
Solomon Islands Dollar*	SBD	6.2880	6.2604	6.3949	6.1355	6.0381	5.8101
South Africa Rand	ZAR	9.0673	8.9844	9.3166	9.1015	8.9161	8.8119
Sri Lanka Rupee	LKR	112.3596	111.1111	113.6364	111.1111	108.6957	102.0408
Sweden Krona	SEK	5.6030	5.6844	5.8532	5.8632	5.8445	5.6332
Swiss Franc	CHF	0.7586	0.7610	0.7767	0.7725	0.7678	0.7457
Taiwan Dollar	TAI	26.0068	25.5374	26.1603	25.5399	24.9674	23.7550
Thailand Baht	THB	27.8855	27.9074	28.4106	27.3628	26.7101	25.3273
Tonga Pa'anga*	TOP	1.5655	1.5301	1.5701	1.5201	1.5064	1.4693
United States Dollar	USD	0.8617	0.8499	0.8758	0.8500	0.8362	0.7808
Vanuatu Vatu	VUV	81.9672	81.3008	83.3333	80.6452	79.3651	75.1880
West Samoan Tala*	WST	1.9098	1.8795	1.9281	1.8755	1.8492	1.7617

Notes to table:

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Source: Bloomberg CMPN BGN

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.

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.

"OTHER REVENUES" DOES NOT INCLUDE CAPITAL AMOUNTS

Case	Vector Limited v Commissioner of Inland Revenue
Decision date	29 August 2014
Act(s)	Income Tax Act 2007
Keywords	"Other revenues", capital, "derived from"

Summary

Vector Limited ("Vector") received lump sum payments for a license to access its tunnel and a share in its easements. The Commissioner of Inland Revenue ("the Commissioner") considered the payments to be assessable as "other revenues" under s CC 1 of the Income Tax Act 2007 ("the ITA"). The High Court held that the payments were capital amounts, and that "other revenues" does not include amounts of capital.

Impact of decision

"Other revenues" in s CC 1(2)(g) of the ITA is not intended to tax amounts of a capital nature.

The Commissioner has appealed this decision.

Facts

The plaintiff (Vector) is an electricity distribution company. Vector owns two electricity distribution networks in the greater Auckland region and derives its income from lines charges. Vector owns various assets including an underground tunnel, easements and freehold land in what is known as the North Shore Transmission Corridor ("NSTC") through which Vector runs its cables.

Transpower New Zealand Ltd ("Transpower") manages and operates the national electricity transmission grid in New Zealand.

Transpower wished to use Vector's infrastructure to upgrade its works. Transpower entered into an agreement with Vector whereby Vector granted Transpower, among other things, a share of its easement rights in the NSTC "(Northern Easements") and an access right to occupy part of Vector's Tunnel ("Southern Access Right"). Transpower paid Vector $3,113,561.64 for the Northern Easements and $50,000,000.00 (plus GST) for the Southern Access Right (the payments).

In the 2011 and 2012 income tax years, Vector returned one-sixth of the payments, being $8,852,260.30 per year as income under s CC 1 of the ITA (Vector spread the payments over six years under s EI 7 of the ITA). Vector then issued a Notice of Proposed Adjustment proposing to adjust its assessable income on the basis that the payments were non-taxable capital receipts. After attending a conference, the parties agreed that the dispute should be truncated and the matter referred to the court for determination.

Decision

Faire J found that "other revenues" in s CC 1(2)(g) of the ITA did not include capital amounts (at [58]). He said that "other revenues" captured amounts that are income, but are not covered by s CC 1(2)(a)–(f). In support of this conclusion, his Honour pointed to the following factors:

1. the plain meaning of "revenue" is income (at [48]);
2. where Parliament intends to tax capital it must use clear language to do so (at [48]);
3. the general purpose of the ITA is to tax income. An amount of capital is not otherwise included in a person's income unless Parliament has intended that to be so by a specific provision – New Zealand does not have a general all-purpose capital gains tax (at [54]);
4. treating "other revenues" as meaning any amount derived from a lease, license or easement would make s CC 1(2) redundant, but the Courts must give effect to the words Parliament has used (at [55]); and
5. the wider context suggests that payments for the grant or transfer of certain rights to land were not included in s CC 1 (at [57]).

Therefore, whether s CC 1 of the ITA applied in this case was answered by determining whether the payments were of a capital or income nature. In deciding that the payments were capital, Faire J applied the principles from *BP Australia Ltd v Commissioner of Taxation of the Commonwealth of Australia* [1966] AC 224 (PC) and *Commissioner of Inland Revenue v McKenzies (NZ) Ltd* [1988] 2 NZLR 736 (CA).

Faire J found that the payments from Transpower were not part of Vector's income-earning process (at [58]). His Honour accepted Vector's submission that it had effectively permanently given up part of its income-producing asset in exchange for a lump sum payment (at [69]).

Faire J noted that the Commissioner was correct that Vector had not legally disposed of its rights to those parts of the tunnel and NSTC that are subject to the agreement with Transpower. However, his Honour found that this was not necessary and that the payments were of a once and for all nature producing advantages to Transpower which were enduring. His Honour concluded that the payments were of a capital nature (at [69]).

Other issues

Although the finding that the payments were not "other revenues" for the purposes of s CC 1 of the ITA was enough to dispose of the case, Faire J went on to briefly express his views on the other two issues.

Is the payment derived "from a lease, license or easement affecting the land"?

Faire J found that the rights which were acquired under the easements and the licence are inseparable from the easements and the licence (at [84]). The payment for those rights was, therefore, "derived from" the licence or easements.

Is the Northern Consideration Amount able to be apportioned?

Faire J was not satisfied that Vector had discharged its onus of providing an appropriate basis for apportionment even if apportionment was possible (at [85]). He said that if it had been necessary to determine the apportionment issue, there may have been justification for granting leave to address further submissions and evidence on it.

APPEAL STRUCK OUT

Case	TRA 011/13; [2014] NZTRA 14
Decision date	26 August 2014
Act(s)	Tax Administration Act 1994, Taxation Review Authorities Act 1994, Taxation Review Authorities Regulations 1998
Keywords	Strike out, appeal, interlocutory, objection

Summary

A successful application was made by the Commissioner of Inland Revenue ("the Commissioner") to strike out a purported appeal of a decision made by the Taxation Review Authority ("TRA") under the Taxation Review Authorities Regulations 1998 ("TRAR").

Impact of decision

This decision confirms that s 26 of the Taxation Review Authorities Act 1994 ("TRAA") does not provide a separate right to appeal from decisions made by the TRA under the TRAR.

Facts

On 7 February 2014, the taxpayer filed a notice of appeal purporting to appeal the decision of the TRA not to make orders under Regulation 6(4) of the TRAR.

The taxpayer had sought orders directing the Commissioner to allow objections made by the taxpayer in relation to several income years. Judge Sinclair determined that the objections in relation to the 1991–94 income years were not competent objections under s 126 of the Tax Administration Act 1994 ("TAA"). Consequently she declined to make the orders sought by the taxpayer ("the Decision").

The Commissioner applied to strike out the appeal on the basis that there was no jurisdiction to appeal the Decision as it was not a "determination of an Authority on any objection" under s 26 of the TRAA.

Decision

The TRA granted the Commissioner's application and made an order striking out the applicant's Notice of Appeal.

In relation to two preliminary issues raise by the taxpayer, Judge Sinclair held, firstly, that the TRA had jurisdiction to determine the Commissioner's present application as the TRA had heard and determined applications to strike out purported appeals on other occasions. The TRA's jurisdiction had not been overruled in the High Court and Court of Appeal which considered the matter.

Secondly, her Honour noted Judge Barber's observations in *Case W48* (2004) 21 NZTC 11,448 that procedural steps taken by the Registry cannot create jurisdiction that otherwise does not exist, and concluded that the TRA is not bound by a procedural step taken by the case manager (who had sent the taxpayer an email accepting the Notice of Appeal).

Judge Sinclair moved on to consider whether s 26(1) of the TRAA which states "[T]he determination of an Authority on any objection shall be subject to appeal to the High Court in any case where …", limited appeals only to determinations of the TRA on any objections, or allowed appeals of interlocutory decisions.

Her Honour noted that s 26 of the TRAA applies only to objections under Part 8 of the TAA. She concluded that there is no right of appeal from the Decision under s 26 of the TRAA as the applicant's objections were not considered to be objections commenced under Part 8.

Judge Sinclair, citing Hammond J's reasoning in *M & J Wetherill Company Limited and Ors v Taxation Review Authority* [2004] 21 NZTC 18,924, found the Decision was of an interlocutory nature as there has not been a determination of an objection on its merits.

In relation to s 27 of the New Zealand Bill of Rights Act 1990 and s 6 of the TAA, her Honour found that there would be no denial of natural justice, or damage to the integrity of the tax system, if the TRA struck out the appeal. She concluded that there was no absolute right of appeal from decisions of the TRA and for such a right to exist the appeal must come within the provisions of s 26(1) of the TRAA.

Finally, Judge Sinclair agreed with the Commissioner that matters the applicant may intend to raise on appeal are irrelevant to this issue and there is no reason to delay hearing the application until the grounds of the appeal have been articulated.

HIGH COURT GUIDANCE ON GST "ASSOCIATED PERSONS" TEST

Case	Concepts 124 Ltd v Commissioner of Inland Revenue
Decision date	5 September 2014
Act(s)	Goods and Services Act 1985, Income Tax Act 2007
Keywords	GST, associated persons, control, voting interests

Summary

When determining whether two entities are associated under the Goods and Services Tax Act 1985 ("GST Act"), the High Court held that the 100% voting interest that one company ("Company A") holds in a second company ("Company B") is attributable to the owner of Company A for the purposes of s 2A(1)(a)(i) of the GST Act.

Facts

This appeal concerns the associated persons test for goods and services tax ("GST") purposes.

Mr Cummings was the sole director of both Concepts 124 Limited ("Concepts") and Ormiston Residential Ltd ("Ormiston"). He also owned 100 per cent of the shares in both Concepts and Ormiston via intermediate holding companies, Working Concepts Ltd ("Working Concepts") and Flatbush Holdings Ltd ("Flatbush"). Flatbush held 75% of the equity in Ormiston for the benefit of the Flatbush Holdings Trust ("the FBH Trust") and 25% for the benefit of Mr Cummings.

In October 2004, Flatbush purchased a property ("the Property") for $847,000, which included GST of $94,111.12. Flatbush later nominated Ormiston as purchaser, and Ormiston began to develop the Property into an apartment block complex. Ormiston was not registered for GST.

In July 2008, Ormiston and Concepts entered into a sale and purchase agreement for the Property which was signed by Mr Cummings on behalf of both companies for a total purchase price of $8,034,750. This purchase price was to be paid in 18 instalments. Ormiston was not GST registered, therefore its sale of the Property to Concepts was not a taxable supply.

Concepts, on the other hand, was GST registered and claimed GST input credits in respect of 17 instalments which were paid during the GST tax periods between July 2008 and October 2009.

However, the Commissioner took the view that Ormiston and Concepts were associated persons. As such, under s 3A(3) of the GST Act, the Commissioner reassessed Concepts as only being entitled to claim an input credit equal to the GST ($94,111.12) included in the purchase price Ormiston paid for the Property, rather than the $799,000 input credit Concepts had claimed, being 1/9 of the second purchase price of $8,034,750.

Concepts challenged the Commissioner's assessment in the TRA. The TRA, in a decision dated 17 December 2013, upheld the Commissioner's approach, finding that Concepts and Ormiston were associated persons under s 2A(1)(a)(iii) of the GST Act.

Concepts appealed the TRA's decision to the High Court on the basis that it was wrong in law.

Decision

Based on the overall scheme and history of the relevant provisions, the High Court concluded that contrary to what was argued by the Commissioner, Concepts and Ormiston were "associated persons" by virtue of s 2A(1)(a)(i) of the GST Act. The High Court held that under s YC 2(1) of the Income Tax Act 2007 ("ITA"), Working Concepts and Flatbush both had 100% voting interests in Concepts and Ormiston respectively. Pursuant to s YC 4(2) of the ITA, those voting interests in Concepts and Ormiston were attributable to Mr Cummings because he owned both Working Concepts and Flatbush [38].

The High Court noted that, if it had accepted the Commissioner's view on the non-applicability of s 2A(1)(a)(i) of the GST Act, it would have agreed with Concepts' submission that the control to which the Commissioner had pointed, being one based on share ownership, would not be a means of control "by any other means whatsoever" [78].

The High Court accepted the Commissioner's alternative argument that Concepts and Ormiston were associated persons pursuant to s 2A(1)(a)(iii) of the GST Act because the combination of Mr Cummings' voting interests in Concepts, his ownership and control of Flatbush, and his power of appointment and removal of trustees in the FBH Trust, meant that he had control of "each of those companies by any other means whatsoever" [79].

The High Court rejected Concepts' argument that s 2A(1)(a)(iii) of the GST Act required the "any other means whatsoever" to be the same means for each of the two companies in question. Clifford J considered that this was an overly strained interpretation of the provision [81].

Despite the way the parties argued the appeal, Clifford J decided that he was not precluded from dismissing Concepts' appeal for reasons other than those argued. As a result, the Commissioner's assessment was confirmed and the appellant was only entitled to an input tax deduction in the sum of $94,111.12 [74 and 82].

APPLICATION FOR EXTENSION OF TIME DISMISSED

Case	Peter William Mawhinney as trustee of the Forest Trust v Commissioner of Inland Revenue
Decision date	11 September 2014
Act(s)	Court of Appeal (Civil) Rules 2005
Keywords	Forest Trust, Peter William Mawhinney, extension of time to file an appeal

Summary

The Court of Appeal dismissed the trustee of the Forest Trust's application for an extension of time to appeal a decision of Cooper J on an application for judicial review.

Impact of decision

If the trustee of the Forest Trust does not seek to appeal this decision, the Court of Appeal has confirmed that the appropriate forum for the substantive issues to be heard is the statutory disputes and challenge procedures.

Facts

This was an application for an extension of time brought by Peter William Mawhinney as trustee of the Forest Trust ("the Trust") under rule 29A of the Court of Appeal (Civil) Rules 2005 to appeal a decision of Cooper J on an application for judicial review (*Mawhinney v Commissioner of Inland Revenue (No 2)* [2013] NZHC 3564, (2013) 26 NZTC 21-079).

The Forest Trust filed a goods and services tax ("GST") return claiming a refund of $67,011.65 for the GST period ended 31 July 2009. The Commissioner of Inland Revenue ("the Commissioner") reassessed the refund to nil pursuant to s 89C(eb) of the Tax Administration Act 1994 ("TAA"), as the Commissioner believed the Trust was involved in fraudulent activity.

The Commissioner issued her assessment on 20 June 2012 and the Trust responded by issuing a Notice of Proposed Adjustment thus engaging the statutory dispute process. Prior to the Commissioner issuing a Challenge Notice (or amended assessment), the Trust filed a Notice of Claim with the Taxation Review Authority. Following a number of interactions between the parties, the Trust filed an application for judicial review relying on the following five causes of action:

1. The Commissioner's adjustment of GST was unlawful and not authorised by s 89C(eb) of the TAA as nothing in the Goods and Services Tax Act 1985 excludes GST from being applied to fraudulent activity.
2. The decision to adjust the GST was in breach of natural justice because of the failure to undertake "naturally just" investigations before making the determination.
3. The failure to reassess the corresponding output tax in the relevant GST period was unreasonable.
4. The Commissioner did not issue her Notice of Response within the two-month response period.
5. There were allegations of breach of statutory duty.

In response, the Commissioner filed an objection to jurisdiction, applying for the proceeding to be dismissed.

On 23 December 2013, Justice Cooper issued his decision in favour of the Commissioner, dismissing Mr Mawhinney's application for Judicial Review (*Mawhinney v Commissioner of Inland Revenue (No 2)* [2013] NZHC 3564, (2013) 26 NZTC 21-079). Justice Cooper held that each of the causes of action could be dealt with in the statutory disputes and challenge procedures and, therefore, applying *Tannadyce Investments Limited v Commissioner of Inland Revenue* [2011] NZSC 158, [2012] 2 NZLR 153, the High Court had no jurisdiction. The judge said that although various bases were argued "the end point in each case involves consideration of the correct GST position" over the period (*Mawhinney v Commissioner of Inland Revenue (No 2)* as above at [45]).

The Trust attempted to appeal this decision to the Court of Appeal but its notice of appeal was rejected for filing by the Deputy Registrar due to a number of procedural defects. Miller J reviewed and upheld the Deputy Registrar's decision to reject the notice of appeal (*Mawhinney v Commissioner of Inland Revenue* [2014] NZCA 69). Accordingly, on 19 March 2014, the Trust filed the application for extension of time, which the Commissioner opposed.

Decision

The Court of Appeal determined that, despite the delay being minimal, it was not in the interests of justice to extend the time for the Trust to "pursue a meritless appeal" (at [19]).

The Court dismissed the application for an extension of time to appeal confirming the High Court's view that there is another statutory remedy available and stating that the "proposed appeal is hopeless" (at [19]).

APPLICATION FOR DISCOVERY DISMISSED BY THE HIGH COURT

Case	ASB Bank Limited v Commissioner of Inland Revenue
Decision date	10 September 2014
Act(s)	High Court Rules, Tax Administration Act 1994
Keywords	Discovery, relevance, shortfall penalties, unacceptable tax position, abusive tax position

Summary

The High Court dismissed ASB Bank Limited's ("ASB") application for discovery from the Commissioner of Inland Revenue ("the Commissioner"), on the basis that the documents sought were not relevant.

Impact of decision

The High Court has restated that relevance (as determined by the pleadings) is the starting point in discovery. If a document is not relevant, it is not discoverable.

This judgment is High Court authority that informal, unfinalised views expressed by internal Inland Revenue staff will not be relevant to the determination of whether a tax position taken is "about as likely as not to be correct" (for the purposes of determining whether an assessment of shortfall penalties for taking an unacceptable tax position is correct).

Facts

ASB's application for discovery sought all documents held by the Commissioner (including emails, meeting notes and minutes) that express a view on the Yen transaction, relevant to whether or not the tax position taken by ASB was "about as likely as not to be correct". In particular, ASB sought documents held by the Commissioner's Policy and Strategy Unit in relation to the second Yen transaction (which was contemplated by ASB but not commenced), documents held by Rulings and any/all other disputes documents held.

The Commissioner opposed the application for discovery on the basis that those documents are not relevant.

Decision

Asher J dismissed ASB's application for discovery. His Honour restated the principle that the starting point for a discovery application is that the documents sought must be relevant to an issue in the proceedings. Relevance in this case is to be considered against the requirements of s 141B(1) of the TAA (unacceptable tax position). Asher

J considered the test under s 141B(1) as stated by the Supreme Court in *Ben Nevis Forestry Ventures Limited v CIR* [2006] NZSC 115 (at 184–185) that the "merits of the arguments supporting the taxpayer's interpretation must be substantial". Thereby reiterating that the test is an objective one, so that the taxpayer's belief as to whether the tax position taken was correct is irrelevant. All tax laws, including the general anti-avoidance provision and decisions of the Courts and Taxation Review Authority on the interpretation of the relevant tax laws are to be considered (s 141B(7) of the TAA).

His Honour noted (at [17]) that the question of discoverability of documents in relation to the issue of whether a taxpayer's tax position had substantial merit has not been directly addressed in New Zealand. Asher J referred to Australian cases (*Prebble v CoT* [2002] FCA 1434, *Walstern v CoT* (2003) 138 FCR) that considered a similar test in the Australian penalties regime and stated that those cases did not suggest that informal views, which were not intended to be communicated to third parties, could be considered. His Honour stated (at [18]) that the observations of Venning J in *Accent Management Ltd v CIR* (2005) 22 NZTC 19,027 (HC) at [360] and [364], is an indication that there were limits as to whether the private opinions held by the Commissioner's officers could be considered.

His Honour further stated (at [19], [21], [23] and [24]) that a judge may get some assistance from commentary on the law and other material of probative value (such as articles by reputable experts and Rulings of the Commissioner) in deciding whether a taxpayer's tax position had substantial merit but that a line must be drawn. Asher J held that "the documents fail the relevance test because their informal nature means they have no significant probative value" (at [22]).

THIS ARTICLE HAS BEEN MASKED FOR LEGAL REASONS

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