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TAX INFORMATION Bulletin

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Inland Revenue
Te Tari Taake

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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.

Below is a selection of items we are working on as at the time of publication. If you would like a copy of an item please contact us as soon as possible to ensure your views are taken into account. You can get a copy of the draft from **www.ird.govt.nz/public-consultation/** or call the Senior Technical & Liaison Advisor, Office of the Chief Tax Counsel on 04 890 6143.

Ref	Draft type/title	Description/background information	Comment deadline
ED0165	Draft General Depreciation Determination – Bench-top Pizza Ovens and Microwave Ovens (Commercial)	A draft General Depreciation Determination ED0165 has been released for public consultation. The draft determination proposes new asset classes for Bench-top Pizza Ovens and Microwave Ovens (Commercial).	21 July 2014

IN SUMMARY

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This article updates the Factual Review process, originally described in the *Tax Information Bulletin* Vol 25, No 2 (March 2013). The key change is that Factual Reviews will no longer be available in situations where an advance pricing agreement could be sought in the alternative.

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This Interpretation Statement replaces items in *Public Information Bulletin* No 51 and *Tax Information Bulletin* Vol 7, No 4, on the income tax treatment of consumable aids. This Interpretation Statement outlines what consumable aids are, when the costs of consumable aids are deductible and when expenditure on consumable aids on hand needs to be added back as income under the accrual rules in s EA 3. It also discusses the requirements of Determination E12 that relate to consumable aid expenditure. If Determination E12 applies, taxpayers are not required to comply with s EA 3.

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The Taxation (Parental Tax Credit) Act 2014 increases the amount of the parental tax credit to $220 per week and extends the payment period to 10 weeks, for babies born on or after 1 April 2015. It also amends the abatement formula so that the parental tax credit is abated against each dollar of family income earned, above the annual threshold, over the entire year.

Parental Leave and Employment Protection Amendment Act 2014 38

The Parental Leave and Employment Protection Amendment Act 2014 extends the period of paid parental leave from 14 weeks to 16 weeks from 1 April 2015, and then to 18 weeks from 1 April 2016.

New legislation (continued)

Cheque Duty Repeal Act 2014 39

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Income Tax (Fringe Benefit Tax, Interest on Loans) Amendment Regulations 2014

The prescribed rate of interest used to calculate fringe benefit tax on low-interest, employment-related loans has increased to 6.13% and applies from 1 July 2014.

Privacy (Information Sharing Agreement between Inland Revenue and New Zealand Police) Order 2014

The Privacy (Information Sharing Agreement between Inland Revenue and New Zealand Police) Order 2014 approves a new information-sharing agreement between Inland Revenue and the New Zealand Police.

Operational statements

2014 review of the Commissioner's mileage rate for expenditure incurred for the business use of a motor vehicle 43

Inland Revenue has reviewed the motor vehicle mileage rate to reflect the average cost of running a motor vehicle, including the average fuel prices, and advises the mileage rate for the 2014 income year will remain at 77 cents per kilometre for both petrol and diesel fuel vehicles.

Questions we've been asked

QB 14/04: Income tax – Depreciation roll-over relief for Canterbury 44

Section EZ 23B of the Income Tax Act 2007 provides roll-over relief for depreciation recovery income received by taxpayers affected by the Canterbury earthquakes. This QWBA clarifies some uncertainties about how to apply the formula that is used to calculate the amount of the depreciation recovery income that can be allocated against the cost of replacement property. The item outlines the depreciation roll-over relief provisions and gives a step-by-step approach, aided by examples, to demonstrate how the formula works. It also sets out the Commissioner's operational approach to certain situations.

QB 14/05: Income tax – ASC rules – calculating the "subscriptions" amount for an amalgamated company when the shares of an amalgamating company are held by another amalgamating company 51

This QWBA addresses a question relating to the calculation of the Available Subscribed Capital (ASC) of an amalgamated company following an amalgamation. The question arose following the release of a QWBA on a related issue (also concerning the calculation of ASC after an amalgamation). This QWBA is released to clarify an additional point that was not addressed in the previous QWBA. The QWBA concludes that the ASC of an amalgamated company does not include the ASC of amalgamating companies that are subsidiaries of other amalgamating companies.

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The Taxation Review Authority found that the disputant was subjectively reckless because, with full appreciation of the risks, he made a conscious decision to understate his income and advanced his own interpretation of the tax legislation. The disputant was found liable for evasion shortfall penalties.

Reconstruction under the "dividend stripping" provision upheld 56

The Taxation Review Authority upheld the Commissioner of Inland Revenue's assessment to reconstruct the disputants' income under section GB 1(3) of the Income Tax Act 2004.

REVENUE ALERT

Revenue alerts inform taxpayers and tax agents about significant and/or emerging tax planning issues or arrangements where Inland Revenue has concerns and is undertaking further risk assessment and investigative activities.

RA 14/01: DONATIONS TAX CREDIT – WHETHER PAYMENTS MADE TO A PRIVATE EDUCATION CENTRE OR CHILDCARE CENTRE ARE GIFTS AND THE DONOR ENTITLED TO A DONATIONS TAX CREDIT; WHETHER PAYMENTS ARE LIABLE TO GST

Explanation

A Revenue Alert is issued by the Commissioner of Inland Revenue, and provides information about a significant and/or emerging tax planning issue that is of concern to Inland Revenue. At the time an alert is issued risk assessments will already be underway to determine the level of risk and to consider appropriate responses.

A Revenue Alert will identify:

- the issue (which may be a scheme, arrangement, or particular transaction) which the Commissioner believes may be contrary to the law or is inconsistent with policy;
- the common features of the issue;
- our current view; and
- our current approach.

An alert should not be interpreted as being Inland Revenue's final position. Rather, an alert outlines the Commissioner's current view on how the law should be applied. For any alert we issue it is likely that some investigatory work has already been carried out.

If people have entered into an arrangement similar to the one described or are thinking about it, they should talk to their tax advisor and/or to Inland Revenue for advice about tax implications.

Issues

Many people make charitable donations each year and receive income tax credits accordingly. However, increasingly Inland Revenue is seeing situations where people are claiming tax credits for purported donations in situations where Inland Revenue considers the payments are not a gift as required by the law.

Any payment of $5 or more to a charity (or some similar public benefit entity) qualifies for a donations tax credit if it is a gift. A payment of money of is a gift when it is:

- made voluntarily;
- for no consideration;
- the giver (or someone else) receives no benefit of a material character by way of return; and
- the payment is made by way of benefaction where the charitable organisation suffers no countervailing material disadvantage.

When deciding whether a payment of money is a gift, the attributes listed above may be interdependent. The true nature of the payment can be determined only by considering the overall arrangements and transactions that gave rise to its payment. Individual circumstances must always be considered. When it is unclear whether a payment is a gift, attributes may need to be balanced to establish the reality of the payment.

Inland Revenue has been investigating arrangements where donations tax credits for donations have been claimed in circumstances where Inland Revenue considers a gift of money may not have been made. These arrangements involve re-characterising (as a gift of money) payments made to attend a private education centre such as a private school or childcare centre which would have not ordinarily been a donation, in order for the payer to receive a donations tax credit.

The payments are generally made to a charitable trust which either operates the education centre directly, or through an arrangement where the charitable trust arranges for an education centre to provide the education services.

In practice the majority of people who make the contributions in question are the parents, or close relatives, of the children attending the education centre. Under these arrangements the parents pay no or low fees for their child to attend a private education centre.

An income tax receipt for the contributions made to the charitable trust during the year is provided to the donor so that the donor can claim a donations tax credit.

Current view on donations tax credits

Inland Revenue considers that, in the absence of evidence of a contrary intention, the contributions made by the parents (or close relatives) in these cases are a substitute for fees and therefore not a gift. This view is based on the fact that the parents pay no or very low fees for the child care or private educational services received in circumstances where a private provider would otherwise have to charge fees for attendance. The payments are not made by way of benefaction. They are made in return for (or in the expectation of) the receipt of education services.

The purported donations are used to meet the running costs of the private education centre, which the education centre would otherwise have to recover from parents by way of attendance or tuition fees. These arrangements merely re-characterise the payments that the education centre relies on to meet their normal running costs. The payments are incorrectly described as "donations" to enable the purported "donor" to make a donations tax credit claim they may not otherwise be entitled to.

GST on supply of private education services

An associated issue is the GST treatment of the payments received by the private education provider. As the payments are made by parents (or close relatives) in return for (or in the expectation of) education services Inland Revenue considers the payments are "consideration" for a supply of services under the GST Act and so are liable to GST.

Inland Revenue does not consider that the money received is an "unconditional gift". Under the GST Act an "unconditional gift" is a payment made voluntarily to a non-profit body and for which "no identifiable direct valuable benefit arises or may arise in the form of a supply of goods and services to the person making that payment, or any other person where that person and the other person are associated persons".

Examples

The following are examples based on some of the arrangements that have been identified so far. There may be other arrangements which involve re-characterising fees as donations.

Example 1

A childcare centre is owned by a trust registered with the Department of Internal Affairs-Charities Services. In order for a child to attend the childcare centre the parents must first pay an enrolment fee. They are then required by the trust to make a contribution of a fixed amount (described as a "donation") per child for each year the child attends the childcare centre. The contribution may be made as a lump sum or by regular payments. No other fees are charged for attendance. A receipt is issued after 31 March each year for the contributions made, to enable the parents to claim a donations tax credit.

Assuming a contribution of $100 per week for 48 weeks, the income tax effect of the above arrangement is:

$4,800 @ 33.3c/$ = $1,599.98 income tax credit

The payment to the trust is not considered to be a valid gift as the money was paid to the trust in return for childcare services.

For GST purposes, the trust treats the contributions as being unconditional gifts and so no GST output tax is paid. Inland Revenue considers that as an identifiable direct valuable benefit arises from the payment, being the provision of childcare services, the payment is not an "unconditional gift" for GST purposes and the payments are subject to GST.

Assuming a contribution of $100 per week for 48 weeks, the GST effect of the arrangement is:

unpaid GST output tax on $4,800 = $626.09*

Example 2

A trust which is a registered charity is established to provide funding for a number of private schools around New Zealand whose values are consistent with the aims of the charity. Funds are raised by asking for contributions from the community to help pay the running costs of the schools which the trust chooses to support. In practice, the requests for contributions are aimed at, and the bulk of the contributions come from, the local school community (the parents and other family members or friends of the children attending (or likely to attend) the schools). These contributions mean that fees which the parents may otherwise have to pay for having their children attend one of these schools are either not necessary or are greatly reduced.

Donors to the trust are able to direct where their contributions are spent. Donors are provided with a receipt each year showing the amount of contributions they have made for the year. These receipts are intended to enable the parents to claim donations tax credits.

Assuming the school funding contributions requested by the trust are $10,000 per year for each child, the income tax effect of this arrangement is:

$10,000 @ 33.3c/$ = $3,330 tax credit

Inland Revenue considers that an objective view of the circumstances of this arrangement leads to the conclusion that the payments were made to the trust by the payer with the expectation that education services would be provided in return. As such, Inland Revenue considers that the payments to the trust are not gifts of money for which a donations tax credit can be claimed.

Where a member of the school community (who does not have a close association with a child who attends or is expected to attend the school) makes a donation to the trust for the benefit of the local school Inland Revenue considers that it is more likely that this is a gift of money for which the donations tax credit can be claimed.

Although this example (unlike example 1) involves a separate trust interposed between the parent and the private school, Inland Revenue considers that the payments made in this type of arrangement may still be made in respect of the supply of educational services and therefore subject to GST.

Assuming the school funding contributions requested by the trust is $10,000 per year for each child, arrangements such as these could have the following GST effect:

unpaid GST output tax on $10,000 = $1,304.35*

* The GST effect in examples 1 and 2 only identifies unpaid output tax. Inland Revenue acknowledges that the education centres will be able to make input tax deductions for GST incurred in providing the education services. However, enquiries made to date indicate that the education centres are already claiming those input tax deduction. Therefore the GST at risk in these examples is the unpaid output tax.

Current status

Inland Revenue has commenced investigations into a number of taxpayers who have entered into childcare or private school funding arrangements like those described above.

Where Inland Revenue considers that donations tax credits have been claimed in situations where a true gift of money has not been made we will recover the excess tax credit from the person making the claim.

If any taxpayer has taken a position which is incorrect for GST, either by treating the contributions as not being subject to GST as unconditional gifts, or not returning output tax as required, that position will be corrected.

Late payment penalties and use of money interest may be applied to taxpayers entering into the types of arrangement described in this Revenue Alert.

Shortfall penalties may also apply, although these may be reduced where a voluntary disclosure is made.

If you consider that our concerns may apply to your situation, we recommend you discuss the matter with your tax advisor or with us, and consider making a voluntary disclosure.

Guidelines for making a voluntary disclosure are contained in our guide *Putting your tax returns right (IR 280)* and *Standard Practice Statement 09/02 Voluntary disclosures (May 2009)*.

This Revenue Alert is issued on 16 May 2014.

Graham Tubb
Group Tax Counsel, Legal & Technical Services

Legislative references
Sections LD 1 and LD 3 of the Income Tax Act 2007
Section 2(1) of the Goods and Services Tax Act 1985

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**

FACTUAL REVIEW PROCESS

After consultation between Inland Revenue and interested taxpayer groups, a Factual Review process was agreed and implemented from 1 October 2012. The process was originally described in an article in the *TIB* Vol 25, No 2 (March 2013).

The purpose of this article is to update the description of the process. The key change is that Factual Reviews will no longer be available in situations where an advance pricing agreement could be sought in the alternative. In addition, references to the post-implementation review have been removed, as this has been undertaken. This article should be treated as replacing the original description.

What is a Factual Review?

The Factual Review process has been established to enhance the utility of binding rulings in situations where a ruling is, or is likely to be, issued subject to a critical factual condition or assumption. The process will give taxpayers an opportunity to obtain a level of certainty from Inland Revenue regarding the likelihood that the condition or assumption will be satisfied.

Who may apply for a Factual Review?

Only taxpayers who have applied for a binding ruling may request a Factual Review. A Factual Review may be requested in writing at any time prior to or immediately following the issue of the ruling. In practice, such a request is likely to arise as a result of Inland Revenue's binding ruling team advising of the need for a critical condition or assumption to the ruling. However, it is possible that the need for such a condition or assumption may be identified as early as the pre-lodgement meeting. In those circumstances, the Factual Review may be carried out in parallel with the consideration of the binding ruling.

A Factual Review may be requested in relation to one or more critical factual conditions or assumptions in the ruling (eg, conditions or assumptions as to value, market rates or generally accepted accounting practice).

However, to ensure that the Commissioner's limited resources are applied to the most appropriate and necessary cases, a Factual Review will only be undertaken in situations where Inland Revenue's Service Delivery Group is satisfied that:

- the factual condition or assumption is both potentially contentious and central to the efficacy of the ruling (eg, in situations where the arrangement may not proceed unless the condition or assumption can be satisfied);
- an advance pricing agreement could not be sought in the alternative; and
- Service Delivery has sufficient resources available to undertake the review.

In addition, the following will be accorded higher priority:

- prospective arrangements (ie, arrangements not yet entered into);
- arrangements of major commercial significance; and
- requests by taxpayers who have entered into a Cooperative Compliance Agreement with the Commissioner.

It is expected, given the requirement that the factual condition must be both contentious and central to the efficacy of the ruling, that the number of qualifying requests for Factual Reviews will be low.

If you wish to apply for a Factual Review this must be done in writing and sent to the following contact address:

Team Manager
Technical Services Unit
Office of the Chief Tax Counsel
Inland Revenue
PO Box 2198
Wellington 6140

Phone: 04 890 6143

Email: **rulings@ird.govt.nz**

What happens when you request a Factual Review?

On receipt of a Factual Review request, Service Delivery will consider whether the eligibility criteria have been satisfied, and will notify the taxpayer accordingly.

Who is responsible for the Factual Review?

Responsibility and management of Factual Reviews will lie with the Investigations and Advice function of Service Delivery. The reviews will be undertaken by principal advisors and specialist staff with expertise in the relevant commercial matters (eg, valuation and financial modelling). Those staff members will typically not be part of the binding ruling team. If Inland Revenue does not retain expertise in a specific discipline, Service Delivery and the taxpayer may agree to engage independent external expertise (with the cost to be borne by the taxpayer).

Where a condition in a prospective arrangement relates to unknown future variables, the Factual Review will focus on the relevant methodology and/or accepted commercial principles.

Service Delivery will liaise with the binding ruling team in order to ensure consistency between the Factual Review and the binding ruling (particularly aspects of the arrangement and the terms of the relevant condition or assumption). If the binding ruling to which the Factual Review relates is withdrawn or the binding ruling team issues a final contrary view, the Factual Review process will end. If the binding ruling team issues an interim contrary view, the Factual Review process may be suspended.

Communication of the outcome of the Factual Review

The outcome of a Factual Review will be communicated by Service Delivery in writing as either a green (positive), amber (neutral) or red (contrary) letter, as follows:

- A green letter confirms that Inland Revenue considers that the relevant condition or assumption will be, or is likely to be, satisfied. However, the condition or assumption will not be removed from the binding ruling. Provided that the taxpayer does not deviate from the factual circumstances that exist when a green letter is issued, Inland Revenue will not seek to further test the condition or assumption by way of audit other than in exceptional circumstances.
- An amber letter indicates that Inland Revenue has not been able to conclude within the amount of time allocated to the Factual Review that the relevant condition or assumption will be, or is likely to be, satisfied. Inland Revenue will not necessarily seek to audit the taxpayer solely as a result of the issue of an amber letter. If the condition or assumption is subsequently tested during an audit, the taxpayer will have a further opportunity to engage with Service Delivery at that time.
- A red letter indicates that Inland Revenue considers that the relevant condition or assumption will not be, or is not likely to be, satisfied, and puts the taxpayer on notice that an audit is likely. If the Commissioner subsequently considers as a result of the audit that the condition or assumption is not satisfied, Inland Revenue will then treat the ruling as not applying (in accordance with the binding rulings legislation). It should be understood that even in cases where a red letter is issued, the Commissioner is still required to issue the associated binding ruling including the relevant condition or assumption, unless the ruling application is withdrawn.

The outcome of a Factual Review will not apply in the event of a material omission or misrepresentation relevant to the review. Similarly, the outcome of a Factual Review will cease to apply if the binding ruling to which it relates ceases to apply (eg, because of a material omission or other circumstance within ss 91EB or 91FB of the Tax Administration Act 1994).

What you need to know about Factual Reviews

What is the status of a Factual Review?

A Factual Review is carried out separately from the binding ruling process, and does not constitute an audit or investigation. Accordingly, the carrying out of a Factual Review will not affect the Commissioner's ability to make a binding ruling under s 91E(4)(g) of the Tax Administration Act 1994. Whilst a green letter is not legally binding on the Commissioner, it does constitute Inland Revenue's considered view regarding that issue, which will not be subsequently revisited and/or overturned other than in exceptional circumstances.

If a taxpayer disagrees with the outcome of a Factual Review, the matter can be taken up with Service Delivery if and when an audit is subsequently commenced. Further, the relevant condition or assumption can be tested through the disputes process in the usual manner.

The period of a Factual Review will match the period of the associated binding ruling.

How long will a Factual Review take?

A Factual Review is an opportunity for taxpayers to enter into a dialogue with Inland Revenue personnel with the relevant experience regarding the likelihood that a factual condition or assumption will be satisfied. Service Delivery will make personnel available for an appropriate amount of time within a 3-month period from the date the request is approved. It is envisaged that during this time there will be on-going discussion with the taxpayer.

It is hoped that within the allocated time agreement may be reached, or that Inland Revenue is able to reach a concluded view, but neither outcome is guaranteed or a requirement of this process. The 3-month period may be extended in exceptional circumstances, but this will be entirely at the Commissioner's discretion.

Once either an agreement or view is reached, or the amount of time allocated to the Factual Review has come to an end (if sooner), the outcome of the review will be communicated in writing to the taxpayer. Depending on the timing, this letter may accompany the draft or finalised binding ruling, or may be issued at a later date. Once the outcome of a Factual Review has been communicated with a taxpayer, no further correspondence will be entered into at that time.

The carrying out of a Factual Review will only affect the timing of the issue of the related draft or final ruling in exceptional circumstances (ie, the issue of a ruling, or completion of the ruling project, will generally not be deferred pending the outcome of the Factual Review).

Who bears the cost of the Factual Review?

There will be no charge made by Inland Revenue to the applicant for a Factual Review. Where Service Delivery and the taxpayer agree to engage independent external expertise, the cost will be borne by the taxpayer. In all cases, the taxpayer will be responsible for the costs of its own personnel and any advisers or experts used or consulted by it.

Information required for a Factual Review

The Factual Review will be based on information provided by the taxpayer for the purposes of the binding ruling application, together with:

- any relevant information supporting the factual position taken;
- any models/methodologies (ie, pricing methodologies, calculations, letters from experts); and
- any further information requested by Service Delivery.

PUBLIC RULINGS BR PUB 14/01–14/05: INCOME TAX – AUSTRALIAN SOURCE INCOME EARNED BY AUSTRALIAN LIMITED PARTNERSHIP AND FOREIGN TAX CREDITS

These five reissued rulings deal with the ability of a New Zealand resident partner of an Australian limited partnership to claim foreign tax credits for Australian income tax and dividend withholding tax paid by the Australian limited partnership. The rulings are contained in a single document with a shared commentary. The rulings apply from the first day of the 2013–14 income year to the last day of the 2016–17 income year.

Note (not part of the Rulings)

These Rulings are a reissue of BR Pub 10/01 to 10/05 and apply from the beginning of the first day of the 2013–14 income year (ie, the date of the expiry of the previous Rulings).

These five Public Rulings, BR Pub 14/01 to BR Pub 14/05, deal with the ability of a New Zealand resident partner of an Australian limited partnership to claim foreign tax credits for Australian income tax and dividend withholding tax paid by an Australian limited partnership. The Rulings do not consider any other situations involving foreign income and foreign tax paid. The Rulings discuss Australian limited partnerships that are corporate limited partnerships for Australian tax purposes and are treated under Australian tax law as companies while in New Zealand they retain partnership and flow through tax treatment.

A foreign tax credit will be available to the New Zealand partners of an Australian limited partnership for Australian income tax or dividend withholding tax that is paid by the limited partnership in certain situations (detailed below). The amount and timing of the tax credit is determined under subpart LJ of the Income Tax Act 2007.

PUBLIC RULING BR PUB 14/01: INCOME TAX – AUSTRALIAN SOURCE INCOME EARNED BY AUSTRALIAN LIMITED PARTNERSHIP AND FOREIGN TAX CREDITS

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 is on ss BH 1, HG 2, LJ 1 and articles 1(2) and 23(3) of the Schedule to the Double Taxation Relief (Australia) Order 2010 (the Australia and New Zealand Double Tax Agreement).

Definitions

For this ruling:

- **Limited partnership** means a partnership that does not meet the definition of company under s YA 1 and is defined as a corporate limited partnership and treated as a company for Australian income tax purposes under Division 5A of the Income Tax Assessment Act 1936 (Aust).
- **New Zealand partner** means a partner that is resident in New Zealand under s YD 1 (residence of natural persons) or s YD 2 (residence of companies) and is not treated as non-resident under a double tax agreement.
- **Australian income tax** means income tax paid to the Australian Government at the company tax rate (as set out in s 23(2) of the Income Tax Rates Act 1986 (Aust)).
- **Partnership share** is defined in s YA 1 as meaning for a particular right, obligation, or other property, status or thing, the share that a partner has in the partnership.

The Arrangement to which this Ruling applies

The Arrangement is as follows:

- Australian source income is earned by an Australian limited partnership that is income to the New Zealand partners under ss HG 2 and CB 35.
- Australian income tax is paid on that income.

To avoid doubt, the Arrangement does not include arrangements where subpart BG applies to void the arrangement.

How the Taxation Laws apply to the Arrangement

The Taxation Laws apply to the Arrangement as follows:

- New Zealand partners in the limited partnership are allowed a foreign tax credit for the Australian income tax paid. The foreign tax credit arises under articles 1(2) and 23(3) of the Australia and New Zealand Double Tax Agreement, and ss BH 1 and LJ 1. Under s HG 2 the tax credit claimed by the New Zealand partners must be in proportion to their partnership share of the income earned by the partnership.

The period or income year for which this Ruling applies

This ruling will apply from the first day of the 2013–14 income year to the last day of the 2016–17 income year.

This Ruling is signed by me on 12 May 2014.

Susan Price
Director, Public Rulings

PUBLIC RULING BR PUB 14/02: INCOME TAX – DISTRIBUTIONS MADE BY AUSTRALIAN LIMITED PARTNERSHIP AND FOREIGN TAX CREDITS

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 is on ss BH 1, HG 2, LJ 1 and articles 1(2) and 23(3) of the Schedule to the Double Taxation Relief (Australia) Order 2010 (the Australia and New Zealand Double Tax Agreement).

Definitions

For this ruling:

- **Limited partnership** means a partnership that does not meet the definition of company under s YA 1 and is defined as a corporate limited partnership and treated as a company for Australian income tax purposes under Division 5A of the Income Tax Assessment Act 1936 (Aust).
- **New Zealand partner** means a partner that is resident in New Zealand under s YD 1 (residence of natural persons) and is not treated as non-resident under a double tax agreement.
- **Australian income tax** means income tax paid to the Australian Government at the company tax rate (as set out in s 23(2) of the Income Tax Rates Act 1986 (Aust)).
- **Dividend withholding tax** means the amount withheld from a dividend to discharge the liability to pay tax on dividends under s 128B of the Income Tax Assessment Act 1936 (Aust).
- **Partnership share** is defined in s YA 1 as meaning for a particular right, obligation, or other property, status or thing, the share that a partner has in the partnership.

The Arrangement to which this Ruling applies

The Arrangement is as follows:

- An Australian limited partnership makes a distribution to its partners and the New Zealand partners are not liable for New Zealand income tax on their partnership share of that distribution.
- Australian income tax in the form of dividend withholding tax is deducted from the payments made to the New Zealand resident partners.

To avoid doubt, the Arrangement does not include arrangements where subpart BG applies to void the arrangement.

How the Taxation Laws apply to the Arrangement

The Taxation Laws apply to the Arrangement as follows:

- New Zealand partners in the limited partnership are not allowed a foreign tax credit for the Australian dividend withholding tax withheld on the distribution made by the limited partnership.

The period or income year for which this Ruling applies

This ruling will apply from the first day of the 2013–14 income year to the last day of the 2016–17 income year.

This Ruling is signed by me on 12 May 2014.

Susan Price
Director, Public Rulings

PUBLIC RULING BR PUB 14/03: INCOME TAX – DISTRIBUTIONS MADE BY AUSTRALIAN UNIT TRUST TO AUSTRALIAN LIMITED PARTNERSHIP AND FOREIGN TAX CREDITS

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 is on ss BH 1, HG 2, LJ 1 and articles 1(2) and 23(3) of the Schedule to the Double Taxation Relief

(Australia) Order 2010 (the Australia and New Zealand Double Tax Agreement).

Definitions

For this ruling:

- **Limited partnership** means a partnership that does not meet the definition of company under s YA 1 and is defined as a corporate limited partnership and treated as a company for Australian income tax purposes under Division 5A of the Income Tax Assessment Act 1936 (Aust).
- **New Zealand partner** means a partner that is resident in New Zealand under s YD 1 (residence of natural persons) and is not treated as non-resident under a double tax agreement.
- **Australian income tax** means income tax paid to the Australian Government at the company tax rate (as set out in s 23(2) of the Income Tax Rates Act 1986 (Aust)).
- **Partnership share** is defined in s YA 1 as meaning for a particular right, obligation, or other property, status or thing, the share that a partner has in the partnership.

The Arrangement to which this Ruling applies

The Arrangement is as follows:

- A distribution, which is a dividend under s CD 1, is made by a unit trust to an Australian limited partnership.
- The limited partnership pays Australian income tax on that distribution.

To avoid doubt, the Arrangement does not include arrangements where subpart BG applies to void the arrangement.

How the Taxation Laws apply to the Arrangement

The Taxation Laws apply to the Arrangement as follows:

- New Zealand partners in the limited partnership are allowed a foreign tax credit for the Australian income tax paid. The foreign tax credit arises under articles 1(2) and 23(3) of the Australia and New Zealand Double Tax Agreement, and ss BH 1 and LJ 1. Under s HG 2 the tax credit claimed by the New Zealand partners must be in proportion to their partnership share of the income earned by the partnership.

The period or income year for which this Ruling applies

This ruling will apply from the first day of the 2013–14 income year to the last day of the 2016–17 income year.

This Ruling is signed by me on 12 May 2014.

Susan Price
Director, Public Rulings

PUBLIC RULING BR PUB 14/04: INCOME TAX – FRANKED DIVIDEND RECEIVED BY AUSTRALIAN LIMITED PARTNERSHIP AND FOREIGN TAX CREDITS

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 is on ss BH 1, HG 2, LJ 1 and articles 1(2) and 23(3) of the Schedule to the Double Taxation Relief (Australia) Order 2010 (the Australia and New Zealand Double Tax Agreement).

Definitions

For this ruling:

- **Limited partnership** means a partnership that does not meet the definition of company under s YA 1 and is defined as a corporate limited partnership and treated as a company for Australian income tax purposes under Division 5A of the Income Tax Assessment Act 1936 (Aust).
- **New Zealand partner** means a partner that is resident in New Zealand under s YD 1 (residence of natural persons) and is not treated as non-resident under a double tax agreement.
- **Australian income tax** means income tax paid to the Australian Government at the company tax rate (as set out in s 23(2) of the Income Tax Rates Act 1986 (Aust)).
- **Franking credit** for Australian tax purposes is defined in s 205-15 of the Income Tax Assessment Act 1997 (Aust).
- **Partnership share** is defined in s YA 1 as meaning for a particular right, obligation, or other property, status or thing, the share that a partner has in the partnership.

The Arrangement to which this Ruling applies

The Arrangement is as follows:

- An Australian limited partnership receives a dividend that has a franking credit attached.
- The New Zealand partners are liable to tax on their partnership share of the dividend received by the limited partnership under ss HG 2 and CD 1. The dividend income derived by the New Zealand partners excludes the amount of franking credits used to reduce the amount of Australian income tax payable.

To avoid doubt, the Arrangement does not include arrangements where subpart BG applies to void the arrangement.

How the Taxation Laws apply to the Arrangement

The Taxation Laws apply to the Arrangement as follows:

- New Zealand partners in the limited partnership are not allowed a foreign tax credit for the franking credit attached to the dividend received by the limited partnership.

The period or income year for which this Ruling applies

This ruling will apply from the first day of the 2013–14 income year to the last day of the 2016–17 income year.

This Ruling is signed by me on 12 May 2014.

Susan Price
Director, Public Rulings

PUBLIC RULING BR PUB 14/05: INCOME TAX – TAX PAID BY AN AUSTRALIAN LIMITED PARTNERSHIP AS A "HEAD COMPANY" AND FOREIGN TAX CREDITS

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 is on ss BH 1, HG 2, LJ 1 and articles 1(2) and 23(3) of the Schedule to the Double Taxation Relief (Australia) Order 2010 (the Australia and New Zealand Double Tax Agreement).

Definitions

For this ruling:

- **Limited partnership** means a partnership that does not meet the definition of company under s YA 1 and is defined as a corporate limited partnership and treated as a company for Australian income tax purposes under Division 5A of the Income Tax Assessment Act 1936 (Aust).
- **New Zealand partner** means a partner that is resident in New Zealand under s YD 1 (residence of natural persons) or s YD 2 (residence of companies) and is not treated as non-resident under a double tax agreement.
- **Australian income tax** means income tax paid to the Australian Government at the company tax rate (as set out in s 23(2) of the Income Tax Rates Act 1986 (Aust)).
- **Partnership share** is defined in s YA 1 as meaning for a particular right, obligation, or other property, status or thing, the share that a partner has in the partnership.

The Arrangement to which this Ruling applies

The Arrangement is as follows:

- An Australian limited partnership is a head company under s 703-15(2) of the Income Tax Assessment Act 1997 (Aust).
- The limited partnership pays income tax in Australia on all the taxable income of the consolidated group.
- The taxable income of the consolidated group in Australia includes income, such as business income earned by Australian subsidiary companies that does not form part of the New Zealand partners' partnership share of the partnership income under ss HG 2 and CB 35.

The Arrangement excludes situations where one or more of the group entities are in a loss position.

To avoid doubt, the Arrangement does not include arrangements where subpart BG applies to void the arrangement.

How the Taxation Laws apply to the Arrangement

The Taxation Laws apply to the Arrangement as follows:

- New Zealand partners in the limited partnership are allowed a foreign tax credit for the Australian income tax paid on the income the limited partnership earns directly (and not through the subsidiary companies). The foreign tax credit arises under articles 1(2) and 23(3) of the Australia and New Zealand Double Tax Agreement, ss BH 1 and LJ 1. Under s HG 2 the tax credit claimed by the New Zealand partners must be in proportion to their partnership share of the income the partnership earns directly.

The period or income year for which this Ruling applies

This ruling will apply from the first day of the 2013–14 income year to the last day of the 2016–17 income year.

This Ruling is signed by me on 12 May 2014.

Susan Price
Director, Public Rulings

COMMENTARY ON PUBLIC RULINGS BR PUB 14/01–14/05

This commentary is not a legally binding statement. The commentary is intended to help readers understand and apply the conclusions reached in the five Public Rulings BR Pub 14/01–BR Pub 14/05 ("the Rulings").

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. Foreign tax credits for Australian tax paid by Australian limited partnerships are available to New Zealand resident partners, in proportion to their partnership share, when all the following are met:
    - the Australian limited partnership is treated as a company for Australian income tax purposes but not for New Zealand tax purposes;
    - the income on which the tax was paid is assessable in New Zealand; and
    - the Australian tax paid was paid on the income that is assessable in New Zealand.

Background

2. The question being considered is whether a foreign tax credit is available to New Zealand residents that earn Australian source income through a limited partnership registered in a state of Australia (that is an Australian limited partnership).
3. BR Pub 14/01 to BR Pub 14/05 are reissues of BR Pub 10/01 to BR Pub 10/05 published in *Tax Information Bulletin* Vol 23, No 1 (February 2011). BR Pub 10/01 to BR Pub 10/05 expired on the last day of the 2012–13 income year.
4. The relevant Australian limited partnerships are those that are treated as corporate limited partnerships for Australian income tax purposes, under s 94D of the Income Tax Assessment Act 1936 (Aust), but do not meet the definition of "company" in s YA 1 of the New Zealand Income Tax Act 2007. The Australian law on limited partnerships registered in Australia and the Australian tax treatment must be considered before looking at the relevant foreign tax credit legislation in New Zealand.

Australian partnerships

5. There are three types of Australian partnerships. The three types are:
    - (ordinary) partnerships;[1]
    - limited partnerships; and
    - incorporated limited partnerships.
6. The three different types of partnerships are taxed differently under Australian income tax law.

(Ordinary) partnerships

7. The first, and most common, type of Australian partnership is an ordinary partnership. The regulation of ordinary partnerships in Australia falls under state law which includes the:
    - Partnership Act 1958 (Victoria);
    - Partnership Act 1892 (New South Wales);
    - Partnership Act 1891 (Queensland);
    - Partnership Act 1963 (Australian Capital Territory);
    - Partnership Act 1891 (South Australia);
    - Partnership Act 1891 (Tasmania);
    - Partnership Act 1997 (Northern Territory); and
    - The Partnership Act 1895 (Western Australia).
8. These Acts provide that an ordinary partnership is the relation between people carrying on a business in common with a view of profit. The partners are jointly and severally liable for the legal actions and debts of the partnership, have management control, share the profits of the partnership in predefined proportions, and have apparent authority as agents of the partnership to bind all the other partners in contracts with third parties. An ordinary partnership is not a separate legal entity.

Limited partnerships

9. The second type of Australian partnership is a limited partnership. Limited partnerships in Australia can be formed and registered only under:
    - Part 3, ss 49–79 Partnership Act 1958 (Victoria);
    - Part 3, ss 50A–81A Partnership Act 1892 (New South Wales);
    - Chapter 3, ss 48–69 Partnership Act 1891 (Queensland);
    - Part 3, ss 47–84 Partnership Act 1891 (South Australia);
    - Limited Partnership Act, 1908 (Tasmania); and
    - Limited Partnership Act, 1909 (Western Australia).
10. The state laws require a limited partnership to satisfy the general law requirements of a partnership (set out at [8] above), as far as they are consistent with the requirements for a limited partnership discussed below. The partnership laws of the Australian Capital Territory and the Northern Territory do not allow for limited partnerships; they only allow for incorporated limited partnerships.
11. The provisions, listed above, provide that a limited partnership is one where there are both general

[1] Referred to as "partnerships" in Australian state legislation.

partners and limited partners. The general partners have the rights and obligations as in an ordinary partnership. The limited partners are not jointly and severally liable for the debts of the partnership and their exposure is limited to their partnership investments, and a corresponding share of the profits. The limited partners also cannot participate in the management of the partnership or act as an agent for the partnership. Despite the limited liability of the limited partner(s), a limited partnership does not have a separate legal identity (unless it is an incorporated limited partnership).

Incorporated limited partnerships

12. The third type of Australian partnership is an incorporated limited partnership. An incorporated limited partnership is a type of limited partnership, but because of its incorporation it is treated differently under Australian law. The Australian Capital Territory, Northern Territory, New South Wales, Queensland, Victoria and South Australia allow incorporated limited partnerships. An incorporated limited partnership is a partnership that must have at least one general partner and one limited partner. Under the relevant state laws, the partnership is a separate legal entity with the powers and capacity of a natural person subject to the limitations in the partnership agreement. As discussed below, an incorporated limited partnership is not a partnership under New Zealand's Income Tax Act 2007 because it is a separate legal entity under Australian state laws. As a result, incorporated limited partnerships are not covered by these Rulings.

Australian tax treatment of Australian limited partnerships

13. A "limited partnership" is defined in s 995-1 of the Income Tax Assessment Act 1997 (Aust)[2] as:
    (a) an association of persons (other than a company) carrying on business as partners or in receipt of ordinary income or statutory income jointly, where the liability of at least one of those persons is limited; or
    (b) an association of persons (other than one referred to in paragraph (a)) with legal personality separate from those persons that was formed solely for the purpose of becoming a VCLP, an ESVCLP, an AFOF or a VCMP and to carry on activities that are carried on by a body of that kind.[3]

Corporate limited partnerships

14. Section 94D of the Income Tax Assessment Act 1936 (Aust), Corporate Limited Partnerships, provides that a limited partnership is a corporate limited partnership if:
    - the year of income is the 1995–96 or later year of income; or
    - the partnership was formed on or after 19 August 1992; or
    - the partnership was formed before 19 August 1992 and either it does not pass the continuity of business test set out in Division 5A at s 94E, or there has been a change in composition of the partnership after 19 August 1992 and no election has been made by the partners under s 94F that the partnership not be treated as a corporate limited partnership; and
    - the limited partnership is not either a foreign hybrid limited partnership[4] in relation to the particular year of income, or a VCLP, an ESVCLP, an AFOF or a VCMP.
15. These rulings only apply to limited partnerships that are also corporate limited partnerships under s 94D of the Income Tax Assessment Act 1936 (Aust). Corporate limited partnerships do not have identities separate from their members. Section 94D excludes certain limited partnerships (VCLP, ESVCLP, AFOF, venture capital management partnerships, and foreign hybrid limited partnerships (defined in footnote 3 below)) from being corporate limited partnerships.
16. Division 5A concerns the taxation of limited partnerships. Nothing in Division 5A of the Income Tax Assessment Act 1936 (Aust) overrides the state partnership laws by recharacterising limited partnerships as companies. Division 5A simply treats a limited partnership that also meets the test for a corporate limited partnership as a company for certain Australian income tax purposes. In particular, subdivision C of Division 5A provides:
    - company includes a reference to a corporate limited partnership (s 94J);
    - partnership does not include a reference to a corporate limited partnership (s 94K);
    - dividend includes a reference to a distribution made by a corporate limited partnership (s 94L).

[2] The definition in the Income Tax Assessment Act 1936 (Aust) is the same and referenced to that in the Income Tax Assessment Act 1997 (Aust).

[3] A VCLP is a venture capital limited partnership and defined in s 118-405(2) of the Income Tax Assessment Act 1997 (Aust); an ESVCLP is an early stage venture capital limited partnership and defined in s 118-407(4) of the 1997 Act; an AFOF is an Australian venture capital fund of funds defined in s 118-410(3) of the 1997 Act and a venture capital management partnership is defined in s 94D(3) of the 1936 Act. In all cases these types of limited partnership must have been registered under Part 2 of the Venture Capital Act 2002 (Aust).

[4] A foreign hybrid limited partnership is formed outside Australia as defined in ss 830-10(1) and (2) of Income Tax Assessment Act 1997 (Aust).

17. This is discussed in the explanatory memorandum to the Taxawtion Laws Amendment Act (No. 6) 1992 (Aust) that accompanied the introduction of subdivision C Division 5A:

> Under the existing law, limited partnerships are treated as partnerships for taxation purposes. However, the structure of a limited partnership is comparable to that of a limited liability company in that there are "limited partners" who are similar to shareholders in a company; they do not take part in the management of the business, and their liability generally is limited to the extent of their investment.
>
> Limited partners are not at risk beyond the limit of their liability. Generally, their liability is limited to their investment. They are not required to make good losses of their partnership, nor are they liable to meet the obligations of the partnership. If limited partners are treated in the same way as partners in any other partnership, however, they may benefit from distributions of losses that exceed their limited liability. Those losses could be used to reduce taxable income, and so tax paid, even though the loss is not one that exposes the partner to any risk of having to meet obligations or make good losses.
>
> State legislation enabling the formation of limited partnerships currently exists in New South Wales, Victoria, Western Australia, Queensland and Tasmania.
>
> **Explanation of proposed amendments**
>
> The Bill will amend the Principal Act to introduce taxation arrangements in new Division 5A of Part III of the Act for taxing limited partnerships …
>
> **The object of this new Division is to ensure that limited partnerships will be treated as companies for taxation purposes. This is not confined to the payment of income tax by limited partnerships, but includes all other purposes under income tax law, including the payment of tax by partners in limited partnerships; for instance, imputation and the taxation of dividends to shareholders …**
>
> [Emphasis added]

Australian tax consolidated groups

18. The introduction of Australia's consolidation rules reinforced that corporate limited partnerships are to be treated as companies for Australian income tax law. The explanatory memorandum to the New Business Tax System (Consolidation) Act (No. 1) 2002 (Aust) makes it clear that corporate limited partnerships can also be head companies within that regime because they are sufficiently equivalent to a company for Australian income tax purposes.

> 3.29 To qualify as a head company, an entity must be a company as defined in s 995-1 of the ITAA 1997.
>
> 3.30 A corporate limited partnership will also satisfy this requirement. This is consistent with the objective of ensuring consolidated groups generally receive a tax treatment like ordinary companies because these partnerships are effectively treated as companies for income tax purposes.

19. The effect of becoming a head company in an Australian consolidated group is that all the income of the group is deemed to have been earned by the head company and not by the individual companies in the group: s 701 of the Income Tax Assessment Act 1997 (Aust).

Application of the Legislation

Australian limited partnerships under New Zealand income tax law

Legislation

20. As these rulings focus on the ability of New Zealand partners to claim foreign tax credits for tax paid or deducted by an Australian limited partnership, the key provisions in the Act are:
    - the definitions of "company", "partnership", and "limited partnership" in s YA 1;
    - section HG 2, which sets out that partnerships are transparent;
    - section CB 35, which sets out that income arising from subpart HG is assessable income to the partner;
    - section BH 1, which sets out the relationship between the Double Taxation Relief (Australia) Order 2010 and subpart LJ. The Schedule to the Double Taxation Relief (Australia) Order 2010 contains the Convention between Australia and New Zealand for the avoidance of double taxation with respect to taxes on income and fringe benefits and the prevention of fiscal evasion (signed 29 June 2009, entered into force 18 March 2010) (the Australia and New Zealand Double Tax Agreement); and
    - subpart LJ, which determines the amount and timing of a foreign credit.

21. In addition to the above provisions, articles 1(2) and 23(3) of the Australia and New Zealand Double Tax Agreement provide New Zealand partners in an Australian limited partnership with relief for Australian income tax and dividend withholding tax paid by the limited partnership.

22. These provisions are discussed below.

Limited partnerships

23. Section YA 1 sets out the definition of a company:

> **Company—**
>
> (a) means a body corporate or other entity that has a legal existence separate from that of its members, whether it is incorporated or created in New Zealand or elsewhere:

(ab) does not include a partnership:

…

(ac) includes a listed limited partnership:

(ad) includes a foreign corporate limited partnership:

(b) includes a unit trust:

…

24. A listed limited partnership and a foreign corporate limited partnership are also defined in s YA 1. In essence, they are defined respectively as a New Zealand or overseas limited partnership that is listed on a recognised exchange, and an overseas limited partnership that is treated as a separate legal entity under the partnership laws of the country concerned.

25. Unless an Australian limited partnership is listed on a recognised exchange or the underlying state partnership laws give it a separate legal personality, it will not meet the definition of a company in New Zealand. This is irrespective of whether it is treated as a company for Australian income tax purposes.

26. Section YA 1 defines:

- "partnership" in paragraph (d) as meaning a limited partnership; and
- "limited partnership" as including an overseas limited partnership as defined in s 4 of the Limited Partnerships Act 2008 but excluding a listed limited partnership or a foreign corporate limited partnership.

27. Section 4 of the Limited Partnerships Act 2008 defines an overseas limited partnership as:

> a partnership formed or incorporated outside New Zealand with—
>
> (a) 1 or more general partners who are liable for all of the debts and liabilities of the partnership; and
>
> (b) 1 or more limited partners who have only limited liability for the debts and liabilities of the partnership

28. Therefore, an Australian limited partnership that:

- meets the definition of an "overseas limited partnership" under s 4 of the Limited Partnerships Act 2008, and
- is not listed on a recognised exchange, and
- is not treated as a separate legal entity in Australia under Australian state partnership laws,

will be treated as a partnership under New Zealand tax law.

Partners in limited partnerships

29. The tax treatment of New Zealand partners in Australian limited partnerships that meet the definition of "partnership" in s YA 1 is set out in s HG 2(2):

> … for a partner in their capacity of partner of a partnership, the amount of income, tax credit, rebate, gain, expenditure, or loss that they have from a particular source, or of a particular nature, is calculated by multiplying the total income, tax credit, rebate, gain, expenditure, or loss of the partners of the partnership from the particular source or of the particular nature by the partner's partnership share in the partnership's income.

30. "Partnership share" is defined in s YA 1 as meaning for a particular right, obligation, or other property, status or thing, the share that a partner has in the partnership.

31. The effect of s HG 2(2) and the definition of "'partnership share" is that the assessable income of partners in a partnership includes their "partnership share" of the partnership income. Section CB 35 also confirms that this is assessable income of the partner:

> A person who is a partner has an amount of income to the extent to which an amount of income results from the application of subpart HG (Joint venturers, partners, and partnerships) to them and their partnership.

32. Section HG 2(2) also makes reference to tax credits. Section LA 10 provides that an amount is a tax credit of a person if it is their tax credit under a provision of Part L. Foreign tax credits arise under subpart LJ so are tax credits under s LA 10. Under s HG 2(2), therefore, partners are entitled to foreign tax credits in proportion to their partnership share.

Foreign tax credits

33. The Australian tax considered in these rulings is income tax and dividend withholding tax. Section BH 1(4) means the Australia and New Zealand Double Tax Agreement has an overriding effect as to New Zealand income tax, including the income and tax credit sections of the Income Tax Act 2007. The income and tax credit sections, therefore, must be read together with the relevant Australia and New Zealand Double Tax Agreement articles. Where there is any inconsistency between the two, the domestic law must be read subject to the Australia and New Zealand Double Tax Agreement. The combined effect of the Australia and New Zealand Double Tax Agreement, and s BH 1 and subpart LJ of the Income Tax Act 2007 is that a New Zealand tax resident is allowed a tax credit for Australian income tax and dividend withholding tax. Articles 1(2) and 23(3) of the Australia and New Zealand Double Tax Agreement provide a New Zealand partner in an Australian limited partnership with relief for income tax or dividend

withholding tax that the limited partnership pays in Australia. The relief is in the form of a tax credit in New Zealand under subpart LJ. Subpart LJ calculates the amount of the tax credit on the basis of a segment of foreign-sourced income under ss LJ 1(1), LJ 1(2)(a), and LJ 2(1):

> **LJ 1 What this subpart does**
>
> **When tax credits allowed**
>
> (1) This subpart provides the rules for dividing assessable income from foreign-sourced amounts into segments and allows a tax credit for **foreign income tax paid in relation to a segment of that income**.
>
> **Limited application of rules**
>
> (2) The rules in this subpart apply only when—
>
> (a) a person resident in New Zealand derives assessable income that is sourced from outside New Zealand; and
>
> …
>
> **LJ 2 Tax credits for foreign income tax**
>
> **Amount of credit**
>
> (1) A person described in section LJ 1(2)(a) has a tax credit for a tax year for an amount of foreign income tax paid on a segment of foreign-sourced income, determined as if the segment were the net income of the person for the tax year. The amount of the New Zealand tax payable is calculated under section LJ 5.
>
> [Emphasis added]

34. A "segment of foreign-sourced income" is defined in s LJ 4 as:

> an amount of assessable income derived from 1 foreign country that comes from 1 source or is of 1 nature.

35. Therefore three key elements must be satisfied for a New Zealand resident partner of an Australian limited partnership to be allowed a foreign tax credit under articles 1(2) and 23(3) of the Australia and New Zealand Double Tax Agreement, and ss BH 1, LJ 1 and HG 2 of the Income Tax Act 2007:
    - A person resident in New Zealand must derive assessable income sourced from outside New Zealand.
    - Foreign income tax must be paid.
    - That foreign income tax must be paid on that foreign-sourced assessable income.

36. It follows that a foreign tax credit is not available where:
    - There is no assessable income calculated under New Zealand tax law.
    - No foreign income tax has been paid.
    - The foreign income tax has not been paid on income that is assessable in New Zealand.

37. The foreign income tax could be Australian income tax or dividend withholding tax as appropriate.

Examples

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

39. This section of the commentary discusses the specific factual scenarios related to each of the five public rulings. In all cases they involve Australian tax being paid, but the issue is whether a foreign tax credit is available to the New Zealand partners. Whether a foreign tax credit is available turns on whether the three key elements set out above at [35] are satisfied.

40. In all five examples the Australian limited partnership ("ALP") has three partners:
    - one general partner ("GP") based in Australia having a 1% partnership share; and
    - two New Zealand resident limited partners ("NZLP 1" and "NZLP 2") with 50% and 49% partnership shares respectively (the 50% and 49% partners). In examples 1, 2 and 5, NZLP 1 and NZLP 2 may be either a company or a natural person but in examples 3 and 4 are natural persons only.

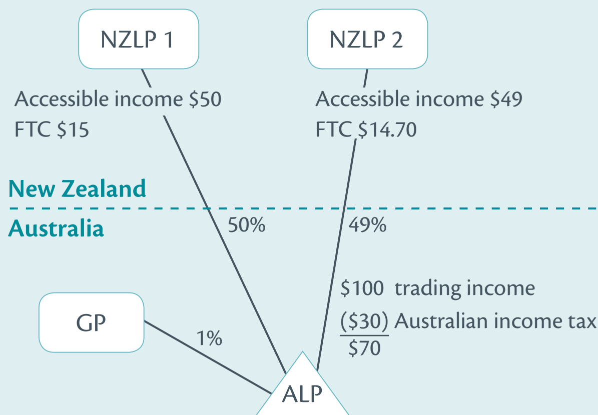
41. The partners in examples 3 and 4 are limited to natural persons. If the partners were New Zealand resident companies the dividends would generally be exempt income under s CW 9(1), and so foreign tax credits would not be available.

    (As an aside, dividends received by a company in New Zealand are not exempt if one of the exclusions in s CW 9(2) applies. The exclusions in s CW 9(2) include dividends paid in relation to rights that are:
    - a direct income interest in a foreign company that is a non-attributing interest in a FIF because it falls within one of the relevant exclusions in s CW 9(2)(a); or
    - a fixed-rate foreign equity (s CW 9(2)(b)); or
    - rights to a deductible foreign equity distribution (s CW 9(2)(c)).

    The Commissioner acknowledges that a New Zealand partner could hold a non-attributing interest in a FIF through an ALP, and any dividends received by a corporate partner in such circumstances would not be exempt income. If a partner's interest is an attributing interest in a FIF, s LJ 2(6) and (7) specify which amount of income is to be used for the foreign tax credit provisions.)

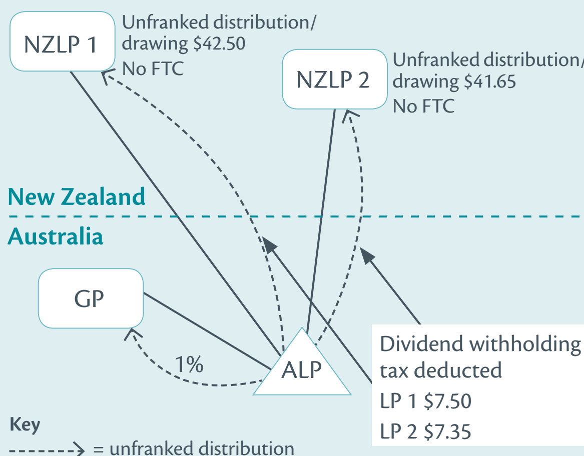
42. The Australian limited partnership is treated as a corporate limited partnership for Australian income tax law but is treated as a partnership for New Zealand income tax law (as discussed above).
43. To avoid currency exchange issues, the reference to "$" is not a reference to any particular currency; it is used simply for illustrative purposes.

Example 1: Australian source income



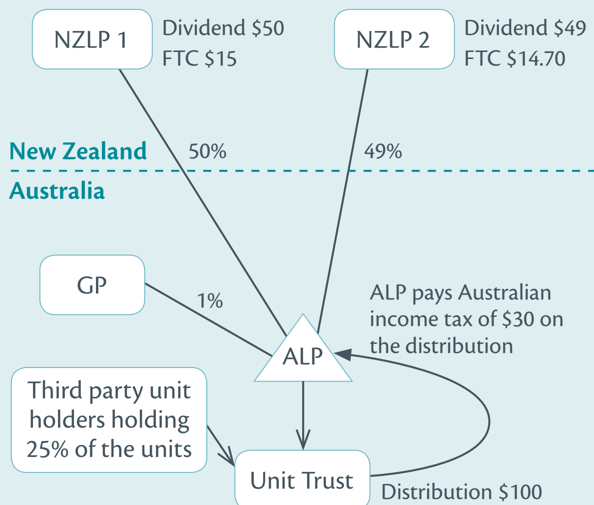
44. ALP earns trading income in Australia of $100 and pays Australian income tax of $30 on it.
45. The trading income is partnership income to the partners, so they must include their partnership share in their New Zealand taxable income. The Australian income tax is allowed as a foreign tax credit in the same proportion as the partner's partnership share. This is because the three key elements are met:
    - The partnership income is assessable to the partners under ss HG 2 and CB 35.
    - The ALP has paid Australian income tax on the income.
    - The Australian income tax was paid on the trading income of the ALP (which is the income that is assessable in New Zealand).
46. In the specific example, the 50% partner—NZLP 1—has assessable income of $50 and a foreign tax credit of $15 and the 49% partner—NZLP 2—has assessable income of $49 and a foreign tax credit of $14.70. These are their respective partnership shares of the trading income and the Australian income tax paid.

Example 2: Distribution made by Australian limited partnership



47. The ALP makes an unfranked distribution to the partners of $100. For Australian income tax purposes, this distribution is treated as a dividend and Australian dividend withholding tax of 15% is deducted. The net amount distributed is then $85 in total.
48. In this situation only the second of the three elements has been met. While the Australian income tax—dividend withholding tax of 15%—has been paid, it has not been paid on New Zealand assessable income. This is because, for New Zealand income tax purposes, the distribution from a partnership would be drawings and not subject to New Zealand income tax.
49. Therefore, no foreign tax credit is available to the New Zealand partners.
50. Example 2, therefore, differs from example 1. In example 1, the partners are treated (under s HG 2) as deriving the income derived by the partnership. As a result, the partners in example 1 are treated as directly deriving the income. The income is taxable in the hands of the partners, and a foreign tax credit is available.
51. In example 2, the payment to the partners is a drawing down of the partners' capital: *Case F123* (1984) 6 NZTC 60,117. The payment does not relate to any income derived by the partnership that has flowed through to the partners under s HG 2. As the payment is drawings it is not taxable in the hands of the partners, and so no foreign tax credit is available.

Example 3: Distribution made from unit trust



52. In example 3, the ALP owns units in a unit trust and the New Zealand partners are natural persons. As noted above at [8] and [10], one of the requirements for an ALP is that it is carrying on a business. The above ALP is in the business of managing various investments (including its investment in the unit trust). As seen above at [23], a unit trust is included in the definition of "company" for New Zealand income tax purposes. The unit trust distributes income of $100 to the ALP and the ALP pays income tax on the distribution of $30.[5]

53. The payment of the distribution from the unit trust to the ALP is a purely domestic transaction in Australia, so article 1(2) of the DTA does not affect Australia's taxation rights on that transaction. This means that Australia is allowed to tax the ALP in example 3 to the extent allowed under its taxation laws (and so is not limited by the dividend article in the DTA to 15%). In accordance with the Australia and New Zealand Double Tax Agreement, New Zealand is required to provide relief in the form of foreign tax credits for the income tax paid in Australia by the ALP on the income that is assessable in New Zealand.

54. Under New Zealand income tax law the distribution from an Australian unit trust is treated as a dividend under s CD 1.

55. In this case all three elements are met:
    - The dividend will be assessable income to the partners under ss CD 1 and HG 2. Australian income tax has been paid.
    - The Australian income tax was paid on the distribution.

56. Therefore a foreign tax credit will be allowed in proportion to the partner's partnership share of partnership income. Under subpart LJ, the foreign tax credit is limited to the notional tax liability that the taxpayer would have paid on the relevant segment of income in New Zealand.[6] In the current example the relevant partners are natural persons, so the tax credit is limited to their marginal tax rate (being 30% in this example). This means that the 50% partner—NZLP 1—has dividend income of $50 and a foreign tax credit of $15, while the 49% partner—NZLP 2—has dividend income of $49 and a foreign tax credit of $14.70.

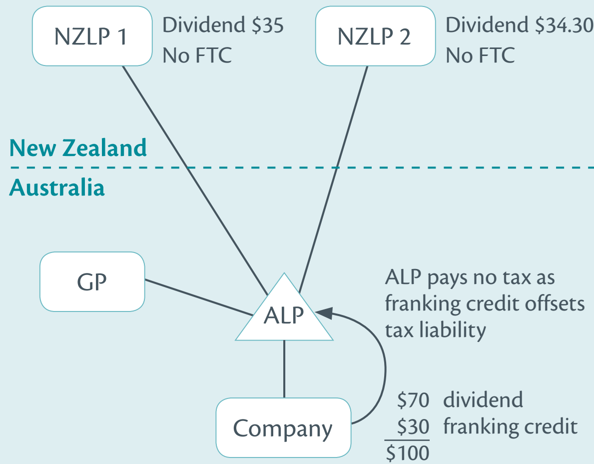
57. If no Australian income tax is paid on the distribution, the New Zealand partners will not be entitled to a foreign tax credit. This example only deals with the situation where the ALP pays Australian income tax on the same segment of income that is taxable to the New Zealand partners (ie, the distribution). The example does not consider whether a foreign tax credit arises where the Australian unit trust pays tax on the income it derives.

58. Example 3 differs from example 2. The difference between the two examples is that there is assessable income in New Zealand in example 3. Specifically, the payment to the partners in example 2 is a drawing down of the partners' capital and so is not assessable income in New Zealand. In contrast, in example 3 the partners are deemed to derive directly the dividend income derived by the partnership under s HG 2. The dividend is assessable income of the partners in New Zealand.

[5] Under Australian tax law, a distribution from a unit trust is taxed as a distribution from a trust or as a dividend from a company (depending on the circumstances of the unit trust). The reference in this example to a distribution includes both situations.

[6] Under s LJ 5, the foreign tax credit is limited by the notional tax liability on the segment of foreign-sourced income determined as if that segment were the person's net income for the tax year. The notional tax liability may be modified as necessary by s LJ 5(4). This means that the amount of the foreign tax credit cannot exceed the amount of tax that would have been payable on the income had a foreign tax credit not been available.

Example 4: Franked dividend received by Australian limited partnership



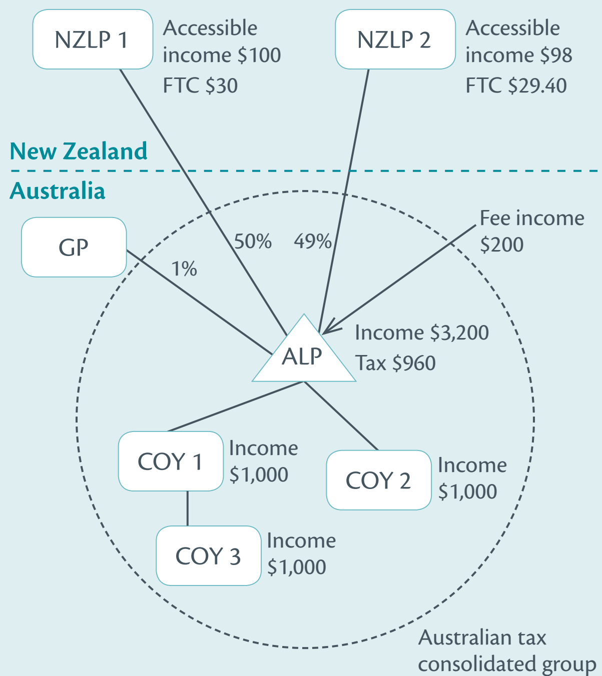
59. The ALP is treated as owning a subsidiary company under Australian tax law. The company pays a $70 franked dividend to the ALP. The New Zealand partners of the ALP are natural persons. The underlying basis of the franking credit was income tax the subsidiary company had paid previously on its trading income. While dividends received by the ALP are subject to tax in Australia, the attached franking credit offsets any tax liability on this dividend so the ALP does not pay tax on that income.

60. In this case, only the first element is satisfied. The dividend is assessable income to the partners under ss CD 1 and HG 2(2). The second and third elements are not satisfied because no Australian income tax has been paid on the dividend by the ALP. In Australia, a franking credit reduces the amount of income tax that a taxpayer has to pay: s 4-10 of the Income Tax Assessment Act 1997 (Aust.). As a result, under the arrangement the ALP had a nil income tax liability for the relevant period, and so paid no income tax. Whatever income tax may have been paid by the subsidiary, the tax was not paid on the segment of income that the New Zealand partners are liable for income tax on (namely the dividend income).

61. In terms of New Zealand assessable income, however, there is dividend income of $35 and $34.30 to the 50% partner and 49% partner respectively. The dividend income derived by the New Zealand partners excludes the amount of franking credits used to reduce the amount of Australian income tax payable.

62. The Commissioner acknowledges that there may be situations where an ALP has insufficient franking credits to reduce the Australian income tax liability to nil. The ALP may then be required to pay the residual income tax liability. The second element would be satisfied in that situation to the extent of the residual income tax paid. In other words, where a dividend is only partially franked or not franked at all, then a foreign tax credit may arise for the income tax actually paid.

Example 5: Tax paid by Australian limited partnership as "head company" of an Australian tax consolidated group



63. The ALP, as the head company for a consolidated group of companies (COY 1, COY 2 and COY 3), pays tax on all the taxable income of the consolidated group in Australia. This example excludes situations where one or more of the group entities are in a loss position.

64. The taxable income of the consolidated group is $3,200 and the income tax paid is $960. The group income includes income from the subsidiary companies of $3,000 and the fee income derived by the ALP of $200.

65. Under s HG 2(1) the New Zealand partners are treated as deriving the fee income derived by the ALP. The fee income is treated as assessable income of the partners sourced from outside New Zealand (satisfying the first element). The ALP has paid income tax on the fee income (satisfying the second

and third elements). As a result, the three elements are met and a foreign tax credit will be available to the partners of the ALP but only to the extent that the tax paid relates to the fee income.

66. As noted above, the first element requires the New Zealand resident partner to derive assessable income sourced from outside New Zealand. The New Zealand partner, therefore, must derive income according to New Zealand tax law. In the case of the income from the Australian consolidated group of companies that income is not derived by the ALP for New Zealand tax purposes.

67. The New Zealand partners must return their share of the income derived directly by the ALP. That is, $100 and $98 for the 50% partner and 49% partner respectively. The New Zealand partners do not need to return income that was derived by the subsidiary companies.

68. A foreign tax credit will be available for the Australian income tax paid on the income earned directly by the ALP (subject to subpart LJ). In this case the foreign tax credit of $30 will be allowed to the 50% partner—NZLP 1—and $29.40 to the 49% partner—NZLP 2.

References

Expired Rulings
BR Pub 10/01 "Australian source income earned by Australian limited partnership and foreign tax credits" *Tax Information Bulletin* Vol 23, No 1 (February 2011): 4–14
BR Pub 10/02 "Distributions made by Australian limited partnership and foreign tax credits" *Tax Information Bulletin* Vol 23, No 1 (February 2011): 4–14
BR Pub 10/03 "Distributions made by Australian unit trust to Australian limited partnership and foreign tax credits" *Tax Information Bulletin* Vol 23, No 1 (February 2011): 4–14
BR Pub 10/04 "Franked dividend received by Australian limited partnership and foreign tax credits" *Tax Information Bulletin* Vol 23, No 1 (February 2011): 4–14
BR Pub 10/05 "Tax paid by an Australian limited partnership as a "head company" and foreign tax credits" *Tax Information Bulletin* Vol 23, No 1 (February 2011): 4–14
Subject references
Foreign tax credit; Limited partnership
Legislative references
Double Taxation Relief (Australia) Order 2010
Income Tax Act 2007 – ss BB 1, BH 1, CB 35, CD 1, HG 2, LJ 1–LJ 4, YA 1 "company", "foreign corporate limited partnership", "limited partnership", "listed limited partnership", "partnership" and "partnership share", YD 1, YD 2
Income Tax Assessment Act 1936 (Aust) – Division 5A, ss 94D, 94E, 94F, 94J, 94K, 94L, 128B
Income Tax Assessment Act 1997 (Aust) – ss 4-10, 4-15, 205-15, 701, 703-15(2), 995-1 "limited partnership"
Income Tax Rates Act 1986 (Aust) – s 23(2)
Limited Partnerships Act 2008 – s 4
Limited Partnership Act 1908 (Tasmania)
Limited Partnership Act 1909 (Western Australia)
Partnership Act 1963 (Australian Capital Territory)
Partnership Act 1892 (New South Wales) – Part 3, ss 50A–81A
Partnership Act 1997 (Northern Territory)
Partnership Act 1891 (Queensland) – Chapter 3, ss 48–69
Partnership Act 1891 (South Australia) – Part 3, ss 47–84
Partnership Act 1891 (Tasmania)
Partnership Act 1958 (Victoria) – Part 3, ss 49–79
Partnership Act 1895 (Western Australia)
Other references
New Business Tax System (Consolidation) Act (No. 1) 2002 (Aust), explanatory memorandum
Taxation Laws Amendment Act (No. 6) 1992 (Aust), explanatory memorandum

APPENDIX: LEGISLATION

New Zealand Tax Legislation

Australia and New Zealand Double Tax Agreement

Articles 1 and 2 provide:

Article 1

Persons covered

1. This Convention shall apply to persons who are residents of one or both of the Contracting States.
2. In the case of an item of income (including profits or gains) derived by or through a person that is fiscally transparent with respect to that item of income under the laws of either State, such item shall be considered to be derived by a resident of a State to the extent that the item is treated for the purposes of the taxation law of such State as the income of a resident.

Article 23

Elimination of double taxation

1. …
2. ...

3. Where, in accordance with paragraph 2 of Article 1, an item of income is taxed in a Contracting State in the hands of a person that is fiscally transparent under the laws of the other State, and is also taxed in the hands of a resident of that other State as a participant in such person, that other State shall provide relief in respect of taxes imposed in the first-mentioned State on that item of income in accordance with the provisions of this Article.

Income Tax Act 2007

Section BH 1 provides:

BH 1 Double tax agreements

Meaning

(1) Double tax agreement means an agreement that—

(a) has been negotiated for 1 or more of the purposes set out in subsection (2); and

(b) has been agreed between—

(i) the government of any territory outside New Zealand and the government of New Zealand; or

(ii) the Taipei Economic and Cultural Office in New Zealand and the New Zealand Commerce and Industry Office; and

(c) has entered into force as a result of a declaration by the Governor-General by Order in Council under subsection (3).

Purposes

(2) The following are the purposes for which a double tax agreement may be negotiated:

(a) to provide relief from double taxation:

(b) to provide relief from tax:

(c) to tax the income derived by non-residents from any source in New Zealand:

(d) to determine the income to be attributed to non-residents or their agencies, branches, or establishments in New Zealand:

(e) to determine the income to be attributed to New Zealand residents who have special relationships with non-residents:

(f) to prevent fiscal evasion:

(g) to facilitate the exchange of information:

(h) to assist in recovering unpaid tax.

Entry into force

(3) An agreement to which subsection (1)(a) and (b) apply enters into force on the date specified by the Governor-General by Order in Council.

Overriding effect

(4) Despite anything in this Act, except subsection (5), or in any other Inland Revenue Act or the Official Information Act 1982 or the Privacy Act 1993, a double tax agreement has effect in relation to—

(a) income tax:

(b) any other tax imposed by this Act:

(c) the exchange of information that relates to a tax, as defined in paragraphs (a)(i) to (v) of the definition of "tax" in section 3 of the Tax Administration Act 1994.

Section CB 35 provides:

CB 35 Amounts of income for partners

A person who is a partner has an amount of income to the extent to which an amount of income results from the application of subpart HG (Joint venturers, partners, and partnerships) to them and their partnership.

Section HG 2 provides:

HG 2 Partnerships are transparent

Look-through in accordance with share

(1) For the purposes of a partner's liabilities and obligations under this Act in their capacity of partner of a partnership, unless the context requires otherwise,—

(a) the partner is treated as carrying on an activity carried on by the partnership, and having a status, intention, and purpose of the partnership, and the partnership is treated as not carrying on the activity or having the status, intention, or purpose:

(b) the partner is treated as holding property that a partnership holds, in proportion to the partner's partnership share, and the partnership is treated as not holding the property:

(c) the partner is treated as being party to an arrangement to which the partnership is a party, in proportion to the partner's partnership share, and the partnership is treated as not being a party to the arrangement:

(d) the partner is treated as doing a thing and being entitled to a thing that the partnership does or is entitled to, in proportion to the partner's partnership share, and the partnership is treated as not doing the thing or being entitled to the thing.

No streaming

(2) Despite subsection (1), for a partner in their capacity of partner of a partnership, the amount of income, tax credit, rebate, gain, expenditure, or loss that they have from a particular source, or of a particular nature, is calculated by multiplying the total income, tax credit, rebate, gain, expenditure, or loss of the partners of the partnership from the particular source or of the particular nature by the partner's partnership share in the partnership's income.

…

Section LJ 1 provides:

LJ 1 What this subpart does

When tax credits allowed

(1) This subpart provides the rules for dividing assessable income from foreign-sourced amounts into segments and allows a tax credit for foreign income tax paid in relation to a segment of that income.

Limited application of rules

(2) The rules in this subpart apply only when—

(a) a person resident in New Zealand derives assessable income that is sourced from outside New Zealand; and

(b) foreign income tax is not paid in a country or territory listed in schedule 27 (Countries and types of income with unrecognised tax) to the extent to which the foreign income tax is paid on the types of income listed in the schedule.

(3) …

Source of dividends

(4) If a company is not resident in New Zealand, and for the purposes of a law of another territory in relation to which a double tax agreement has been made is resident in that territory, and the law imposes foreign tax, a dividend paid by the company is treated as being derived from a source in that other territory for the purposes of the double tax agreement.

Double tax agreements

(5) This subpart and sections BH 1 (Double tax agreements) and CD 19(1) (Foreign tax credits and refunds linked to dividends) and section 88 of the Tax Administration Act 1994 as far as they are applicable, and modified as necessary, apply for the purposes of section LJ 2, as if that section were a double tax agreement.

Relationship with section YD 5

(6) Section YD 5 (Apportionment of income derived partly in New Zealand) applies to determine how an amount is apportioned to sources outside New Zealand.

Section LJ 2 provides:

LJ 2 Tax credits for foreign income tax

Amount of credit

(1) A person described in section LJ 1(2)(a) has a tax credit for a tax year for an amount of foreign income tax paid on a segment of foreign-sourced income, determined as if the segment were the net income of the person for the tax year. The amount of the New Zealand tax payable is calculated under section LJ 5.

Limitation on amount of credit

(2) The amount of the person's credit in subsection (1) must not be more than the amount of New Zealand tax payable by the person in relation to the segment calculated under section LJ 5(2), modified as necessary under section LJ 5(4).

Amount adjusted

(3) The amount of the person's credit in subsection (1) may be reduced or increased if either section LJ 6 or LJ 7 applies.

…

Sections LJ 3 and 4 provide:

LJ 3 Meaning of foreign income tax

For the purposes of this Part, foreign income tax means an amount of income tax of a foreign country.

LJ 4 Meaning of segment of foreign-sourced income

For the purposes of this Part, a person has a segment of foreign-sourced income equal to an amount of assessable income derived from 1 foreign country that comes from 1 source or is of 1 nature.

Section YA 1 provides:

Section YA 1

company—

(a) means a body corporate or other entity that has a legal existence separate from that of its members, whether it is incorporated or created in New Zealand or elsewhere:

(ab) does not include a partnership:

…

foreign corporate limited partnership means an entity or group of persons that—

(a) meets the definition of **overseas limited partnership** in section 4 of the Limited Partnerships Act 2008; and

(b) is treated as a separate legal entity under the laws (other than taxation laws) of the country, territory, or jurisdiction where it is established

limited partnership—

(a) means a limited partnership registered under the Limited Partnerships Act 2008; and

(b) includes an "overseas limited partnership" as defined in section 4 of that Act; and

(c) despite paragraph (a) or (b), does not include a listed limited partnership or a foreign corporate limited partnership

listed limited partnership means an entity or group of persons that is listed on a recognised exchange, and that entity or group of persons—

(a) is a limited partnership registered under the Limited Partnerships Act 2008; or

(b) meets the definition of overseas limited partnership in section 4 of that Act

partnership means—

(a) a group of 2 or more persons who have, between themselves, the relationship described in section 4(1) of the Partnership Act 1908:

(b) a joint venture, if the joint venturers all choose to be treated as a partnership for the purposes of this Act and the Tax Administration Act 1994:

(c) co-owners of property, other than persons who are co-owners only because they are shareholders of the same company, or settlors, trustees, or beneficiaries of the same trust, if the co-owners all choose to be treated as a partnership for the purposes of this Act and the Tax Administration Act 1994:

(d) a limited partnership

partnership share means, for a particular right, obligation, or other property, status, or thing, the share that a partner has in the partnership

New Zealand partnership legislation

Partnership Act 1908

Part 1 provides:

4 Definition of partnership

(1) Partnership is the relation which subsists between persons carrying on a business in common with a view to profit.

(2) But the relation between members of any company or association registered as a company under the Companies Act 1955 or the Companies Act 1993 or any other Act of the General Assembly for the time being in force and relating to the registration of joint stock, trading, or mining companies, or formed or incorporated by or in pursuance of any other Act of the General Assembly or letters patent, or Royal Charter, is not a partnership within the meaning of this Act.

Limited Partnership Act 2008

Section 4 provides:

overseas limited partnership means a partnership formed or incorporated outside New Zealand with—

(a) 1 or more general partners who are liable for all of the debts and liabilities of the partnership; and

(b) 1 or more limited partners who have only limited liability for the debts and liabilities of the partnership

Australian Tax Legislation

Income Tax Assessment Act 1936

Sections 94D(1) and (2) provide:

94D(1) [Interpretation]

For the purposes of this Division, a limited partnership is a corporate limited partnership in relation to a year of income of the partnership if:

(a) the year of income is the 1995-96 year of income or a later year of income; or

(b) the partnership was formed on or after 19 August 1992; or

(c) both:

(i) the partnership was formed before 19 August 1992; and

(ii) the partnership does not pass the continuity of business test set out in section 94E; or

(d) all of the following apply:

(i) the partnership was formed before 19 August 1992;

(ii) a change in the composition of the partnership occurs during the period:

(A) beginning on 19 August 1992; and

(B) ending at the end of the year of income;

(iii) the partners do not elect, in accordance with section 94F, that the partnership is not to be treated as a corporate limited partnership in relation to the year of income.

94D(2) [Exceptions]

However, a partnership that is a VCLP, an ESVCLP, an AFOF or a venture capital management partnership cannot be a corporate limited partnership.

Income Tax Assessment Act 1997

Section 995-1 provides:

limited partnership means:

(a) an association of persons (other than a company) carrying on business as partners or in receipt of *ordinary income or *statutory income jointly, where the liability of at least one of those persons is limited; or

(b) an association of persons (other than one referred to in paragraph (a)) with legal personality separate from those persons that was formed solely for the purpose of becoming a *VCLP, an *ESVCLP, an *AFOF or a *VCMP and to carry on activities that are carried on by a body of that kind.

Income Tax Rates Act 1986

Section 23 provides:

23(2) [Companies generally]

The rate of tax in respect of the taxable income of a company not being:

(a) a life insurance company; or

(b) an RSA provider; or

(ba) an FHSA provider; or

(c) a company to which subsection (4) or (5) applies;

is 30%.

INTERPRETATION STATEMENTS

This section of the *TIB* contains interpretation statements issued by the Commissioner of Inland Revenue.

These statements set out the Commissioner's view on how the law applies to a particular set of circumstances when it is either not possible or not appropriate to issue a binding public ruling.

In most cases Inland Revenue will assess taxpayers in line with the following interpretation statements. However, our statutory duty is to make correct assessments, so we may not necessarily assess taxpayers on the basis of earlier advice if at the time of the assessment we consider that the earlier advice is not consistent with the law.

IS 14/03: INCOME TAX – CONSUMABLE AIDS

All legislative references are to the Income Tax Act 2007 unless otherwise stated. Relevant legislative provisions are reproduced in the Appendix to this Interpretation Statement.

This statement updates and replaces the item "Consumable aids to manufacture or production—what they are and when to claim as a deduction" published in *Public Information Bulletin* No 51 (September 1969): 11 and the item "Consumable aids – deductibility of cost" published in *Tax Information Bulletin* Vol 7, No 4 (October 1995): 13. Both items deal with the income tax treatment of consumable aids. The current relevance of this information was identified during a review of content published in *Public Information Bulletins* and *Tax Information Bulletins* before 1996. The *Public Information Bulletin* review has now been completed, see "Update on Public Information Bulletin review" *Tax Information Bulletin* Vol 25, No 10 (November 2013): 37.

Summary

1. Consumable aids are goods or materials that are used in the manufacture or production of goods or in the performance of services. These goods and materials are completely consumed or become unusable or worthless in a relatively short period after being applied in the process of deriving income. They do not become a component part of a finished product. Examples of consumable aids are the fertiliser used by a farmer, fuel in a car used in a business and certain short-life grinding wheels used in a mill.
2. The cost of acquiring a consumable aid is deductible when incurred in deriving income. However, if the provisions of s EA 3 apply, the expenditure incurred on consumable aids that are not used up in deriving income at the end of a person's income year is included in that person's income for the year.
3. Under Determination E12 a person is excused from complying with s EA 3 if they have an unexpired portion of expenditure on consumable aids of $58,000 or below at the end of the income year. To be excused from complying with s EA 3 under Determination E12, consumable aids must be in the possession of the person at balance date and the deduction of the expenditure must not have been deferred to a subsequent income year for financial reporting purposes.

Analysis

4. We outline below what a consumable aid is, how the expenditure on consumable aids is deductible, when expenditure on consumable aids needs to be added back under s EA 3 and how Determination E12 applies to consumable aids.

What is a consumable aid?

5. The term "consumable aid" is referred to, but not defined, in the Act. Consumable aids used in the production of trading stock are specifically excluded from the definition of "trading stock" for the trading stock valuation provisions (s EB 2(3)(g)).
6. New Zealand cases have looked at what a consumable aid is in the context of trading stock. We note that the following cases were decided when the term "consumable aid" did not appear in the relevant Income Tax Act and consumable aids were not specifically excluded from trading stock. However, we consider that these cases are still good authority on what is a consumable aid.
7. The consumable aid concept was referred to in *Case N32* (1991) 13 NZTC 3,280. The case concerned a New Zealand manufacturing plant that was part of a group of companies owned by an overseas company. The case looked at balance date adjustments for work in progress, pre-payments and consumable aids made for the 1986 and 1987 income years.
8. Barber DJ said about consumable aids, at 3,287:

> [A] distinction is drawn in tax law between consumable aids and stock in trade. **Consumable aids are articles or materials which, without becoming**

> **component parts of a finished product**, are used in the manufacture or production of goods from which a taxpayer derives its assessable income, **and are either completely or almost completely consumed or become unusable or worthless after being once applied in the process.** What is a consumable aid varies according to the business carried on. For example, as Mr Bonnar suggested, a sack of coal is stock in trade of a coal merchant, but a consumable aid of a pottery manufacturer. I agree that each case must be considered on its own facts taking into account the nature of each item used, the extent to which the item lends itself to repetitive use, and the rate of consumption to be expected from the day to day carrying on of the enterprise of the manufacture.
>
> Generally speaking, expenditure on consumable aids is a cost of business and, therefore, such expenditure may be deducted in the year of expenditure.
>
> [Emphasis added]

9. In *Case E98* (1982) 5 NZTC 59,522, the Taxation Review Authority had to determine whether the cost of bales of hay included in the purchase of a dairy farm was deductible. Part of the hay was sold on and part was used as stock feed on the farm. Bathgate DJ said the following about consumable aids, at 59,529:

> A "consumable aid" is a term recognised and used in taxation practice, although it is not referred to in the *Income Tax Act* 1976. **"Consumable aids" are goods or produce** such as cleaning agents, fuel and **other aids to, and consumed in, manufacture or production**. They are no more than aids or stores used or consumed in manufacture or production. Their nature and use distinguish these items from trading stock, as illustrated in 4 N.Z.T.B.R. *Case 16.*
>
> [Emphasis added]

10. In *Case 16* (1968) 4 NZTBR 185, the Taxation Board of Review concluded that grinding wheels with a life of 9–24 days and furnace bricks with a life of about 2½ weeks used in a steel foundry were consumable aids and not trading stock or loose tools. The board agreed with the opinions expressed and the conclusions reached about "consumable aids to manufacture" in the earlier Australian decision *Case 120* (1951) 1 CTBR (NS) 568 (discussed further below). This was on the basis that consumable aids are articles or materials that are used up in the manufacturing process, do not become a part of the goods for sale, and become unusable or worthless after one use or lend themselves to limited repetitive use. In distinguishing consumable aids from capital assets, the board summarised at 194:

> Each case will therefore involve a consideration not only of the nature of the item used but also of such factors as the extent to which it lends itself to repetitive use, the rate of consumption to be expected in the day-to-day carrying on of a company's enterprise and, as a corollary to the last-mentioned consideration, whether the volume of purchases is appropriate to the proximate needs of the manufacturer concerned.

11. In *Case 120*, the Australian Taxation Board of Review had to decide whether certain goods were consumable aids or trading stock. The board held that chemicals, cleaning fluids and various other articles used in manufacture were consumable aids because they did not become component parts of finished products and were not goods purchased for manufacture. Taxation Board of Review member F C Bock classified the different types of goods the company had recorded under "non-trading stocks" and stated at 571:

> **Goods (purchased by the company) which are rapidly consumed** in the course of being applied in the company's manufacturing processes **but do not**, to any extent, except, perhaps, adventitiously, **become integral parts of the finished products**.
>
> …
>
> Their nature and functions are such that nearly all of them would be used up, or become unusable and worthless, as the result of being applied once in a manufacturing process and that **others** (only one or two), **although capable of limited repetitive use, have a very short life. Such goods are sometimes described as "consumable aids to manufacture"** and I shall refer to them by that description.
>
> [Emphasis added]

12. At 592, F C Bock concludes that cleaning agents and other aids to manufacture recorded under "non-trading stocks" do not form part of the trading stock of the company and states:

> The purpose for which they [the cleaning agents and other aids to manufacture] were acquired was not for sale or exchange either in their existing form or in a processed form suitable for sale or exchange. They comprised materials used for purposes ancillary to the business of manufacturing goods for sale and do not form a component part of such goods produced or manufactured; at no time does possession of or property in these materials pass from the company to its customers; as consumed in the process of working up raw materials into finished goods ready for sale they constitute an expense to the company which is comparable to the losses or outgoings incurred on wages of factory employees (clerks, storemen, etc.) not directly engaged in the manufacturing process.

13. From the above cases, it can be concluded that consumable aids are goods or materials to which all of the following criteria apply:
    - They are used in the manufacture or production of goods or services from which a person derives income.

- They are completely, or almost completely, consumed at a rapid rate, or become unusable or worthless after being once applied (in the production process), or are capable of limited repetitive use.
- They are not component parts of a finished product (or goods acquired for further processing that become part of a finished product).
- As opposed to capital assets, they are consumed at a rapid rate or have a very short life.

What a consumable aid is varies according to the business carried on.

14. As noted above, consumable aids have been expressly excluded from the definition of "trading stock": s EB 2(3)(g). Consumable aids are distinguishable from raw materials because consumable aids do not end up being part of the final product. Consumable aids are also generally distinguishable from spare parts because most spare parts are neither completely consumed nor become unusable or worthless in a relatively short period after being applied in the process of deriving income.

How are consumable aids different from raw materials and spare parts?

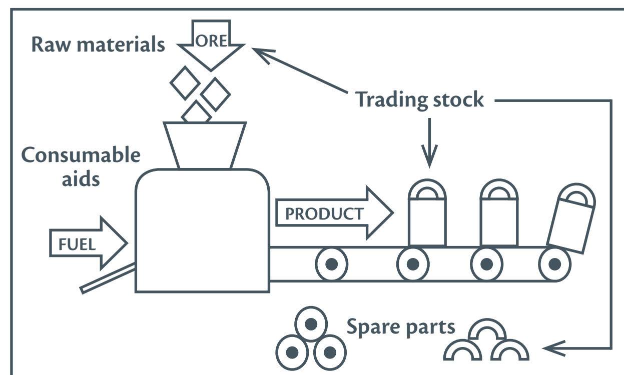
15. Consumable aids are distinguishable from raw materials. Raw materials, like consumable aids, are used in the manufacturing process. However, unlike consumable aids, raw materials are acquired to become an integral part of the finished product. Raw materials are included in the definition of "trading stock" in s EB 2(2)(b): "materials that the person has for use in producing trading stock". This means that raw materials are valued as trading stock under subpart EB. The value of a person's trading stock at the end of each income year is income of the person in the income year (ss CH 1(2) and EB 3).

16. Spare parts are used to repair or replace components of an asset or item. Spare parts can be either trading stock or used to maintain plant that is used to derive income. Spare parts used to maintain plant are similar to consumable aids because they are used in the production process and may not actually be absorbed into any final product. Often spare parts are used when the plant or machinery breaks down or requires maintenance. This often results in the spare parts being used for a relatively long period after being applied. For this reason, most spare parts will not meet the consumable aid requirement of being completely consumed or becoming unusable or worthless in a relatively short period after being applied in the process of deriving income.

17. Section EB 2(3)(h) specifically excludes "a spare part not held for sale or exchange" from the definition of "trading stock". The deductibility of expenditure on spare parts is determined under general principles (general deductibility in s DA 1, and general limitations in s DA 2(1) to (6)). As opposed to consumable aids, spare parts that fall under the prepayment rules in s EA 3 do not get the benefit of Determination E12. This determination is discussed further below.

18. Most spare parts will be easily distinguishable from consumable aids because they are either trading stock or are usable for a relatively long period of time after being applied. However, there may be some goods and materials that taxpayers describe as spare parts but that also fit the description of consumable aids as outlined in this statement. These spare parts are also consumable aids and Determination E12 applies accordingly.

19. The following diagram illustrates in general terms the distinction between consumable aids, raw materials and spare parts:



Deductibility of expenditure on consumable aids

20. As previously mentioned, consumable aids to be used in the process of producing trading stock are specifically excluded from the definition of "trading stock" by s EB 2(3)(g). Therefore, they are not valued under the trading stock valuation provisions in subpart EB. There is no specific legislative regime or provision dealing with the deductibility of expenditure on consumable aids. Therefore the deductibility of expenditure on consumable aids must be determined by general principles under ss DA 1 and DA 2.

21. The cost of a consumable aid will usually be expenditure incurred in deriving income or carrying on a business for the purpose of deriving income. Consequently, the cost of a consumable aid will be deductible under the general permission in s DA 1(1) and the deduction will not usually be denied under the general limitations in ss DA 2(1) to (6).

Section EA 3 and consumable aids

22. While expenditure on buying consumable aids is deductible when incurred, this type of expenditure is also subject to s EA 3 (Prepayments). Section EA 3 sets out how to treat prepayments, where a prepayment is expenditure that the taxpayer has incurred and is allowed as a deduction but there is an unexpired portion of that expenditure at the end of the income year. Section EA 3(3)(a) provides that the unexpired amount of expenditure has to be added back as income in the same year under s CH 2. Section EA 3(3)(b) provides that this unexpired amount is deductible under s DB 50 in the following income year. Section EA 3 will be applied to this expenditure again at the end of the following income year if there is still an unexpired portion.

23. Section EA 3 explains what "unexpired" means for expenditure on goods, services and choses in action. In the context of consumable aids, the meaning of "unexpired" in relation to goods is relevant. For goods, an amount of expenditure is unexpired if the goods are not used up in deriving income and are not destroyed or rendered useless for the purposes of deriving income by the end of the income year.

Meaning of "used up"

24. There has been some uncertainty concerning at what stage a consumable aid is "used up" in terms of s EA 3(4). The words "used up" in s EA 3(4) have their ordinary meaning in this context, being "consume or expend the whole of something" (see *Concise Oxford English Dictionary*, 12th ed, Oxford University Press, New York, 2011).

25. A good has been used up in terms of s EA 3(4) when it has been expended through being consumed or incorporated into other assets in deriving income. The focus is on whether a good continues to exist and be available for deriving income beyond the income year. This is consistent with the policy intent of the provision and case law considering s 104A of the Income Tax Act 1976, the predecessor to s EA 3.

26. The concept of making adjustments for prepaid expenditure was first introduced into tax legislation in 1987 as part of the new timing or accrual rules. These rules were brought in "… to achieve a much closer matching of the timing of deductions and the timing of income recognition for tax purposes" (see the Minister's preamble in the October 1986 Consultative Document on Accrual Tax Treatment of Income and Expenditure).

27. This is consistent with the Court of Appeal decision in *Thornton Estates Ltd v CIR* (1998) 18 NZTC 13,577. This case considered whether a land developer had to add back expenditure on sections that had undergone subdivision and substantial development work but had not sold at the end of the income year.

28. Section 104A(2)(a) of the Income Tax Act 1976 had the word "used" instead of the words "used up", which are in s EA 3(4). However, the court in *Thornton Estates* found that "used" in the context of s 104A(2)(a) did not mean goods applied or employed in the income producing process. Rather, the court found that "used" only referred to goods "used up" in the income producing process.

29. The court saw the purpose of s 104A of the Income Tax Act 1976 was to "achieve a closer matching of the timing of deductions and income recognition for tax purposes". The taxpayer was allowed the deduction when the purchased goods were "expended through being consumed or incorporated into other assets" (at 13,583). The court considered the statutory description of "unexpired portion" reinforced this by referring to that which is left. The change in wording from "used" to "used up" since *Thornton Estates* seems to strengthen this.

Consumable aids used to produce other consumable aids

30. Sometimes consumable aids are used to produce other consumable aids to be used in a business. A common example of this is home-grown stock food, where a farmer uses consumable aids, such as seeds and fertiliser, to produce silage to be used on the farm. There has been some uncertainty as to how s EA 3 applies to those types of consumable aids.

31. Section EA 3(4), as it applies to consumable aids, requires the unexpired portion of a person's expenditure **on goods** to be added back, directly linking the goods and the expenditure when determining the unexpired portion that is income under s EA 3(3)(a). Section EA 3 applies in the same way in the context of consumable aids used to produce other consumable aids. That is, to determine whether an amount of expenditure on consumable aids is unexpired, the enquiry under s EA 3(3) is whether the goods have been used up in deriving income or destroyed or rendered useless for the purposes of deriving income. In the example of home-grown silage, the seeds are used up when they are planted and the fertiliser is used up with spreading.

This is because they do not continue to exist as seeds and fertiliser and do not continue to be available as seeds and fertiliser. There is therefore no amount of expenditure on the planted seeds and spread fertiliser that is unexpired in terms of s EA 3. If, however, the consumable aids are used to produce trading stock (eg, stock feed to be sold), then the person has to value the produced trading stock under the trading stock valuation regime in subpart EB with the closing value of the trading stock being income under s CH 1(2).

How does Determination E12 apply to consumable aids?

32. Section EA 3(8) provides the Commissioner with the discretion to excuse certain persons from complying with s EA 3. The Commissioner has used the discretion under s 91AAC of the Tax Administration Act 1994 and issued Determination E12: Persons excused from complying with s EA 3 of the Income Tax Act 2007 (DET E12). DET E12 specifically covers consumable aids (see row (d) of the Schedule to DET E12).

33. Under DET E12, a taxpayer does not have to add back the expenditure incurred on the purchase of consumable aids as income under s EA 3 if:

    - the total of the expenditure on consumable aids that is unexpired at balance date does not exceed $58,000; and
    - the consumable aids are in the possession of the taxpayer at balance date; and
    - the deduction of the expenditure has not been deferred to a subsequent income year for financial reporting purposes.

34. Under DET E12, a person is excused from complying with s EA 3 when the unexpired portion of the expenditure on all consumable aids in total is no more than $58,000 at the end of the income year. This means expenditure of $58,000 or less on the purchase of consumable aids that are not used up does not have to be added back as income of the person. However, if the unexpired portion of expenditure on the purchase of all consumable aids exceeds $58,000 at the end of the income year, the person does not get the benefit of DET E12 and s EA 3 applies to the total amount of expenditure.

35. However, DET E12 only applies to expenditure on goods (listed in the Schedule to DET E12) to the extent that the goods are in the person's possession at balance date (see cl 4(d)) and to the extent that the deduction of the expenditure has not been deferred to a subsequent income year for financial reporting purposes (see cl 4(e)). This means that the person has to add back the expenditure for consumable aids that are not in their possession at balance date. This is even if the total unexpired portion of expenditure for the purchase of consumable aids is below the threshold of $58,000.

36. This raises the question of the meaning of "possession" in DET E12 cl 4(d). The ordinary meaning of "possession" indicates that ordinarily "possession" is not equal to legal ownership and requires some form of power or control over the thing in possession. The inclusion of the words "in the", preceding the word "possession" in cl 4(d), also suggests that possession in this context means the goods need to be in the control of the taxpayer. This view is consistent with the common law meaning of the word "possession". The context in which the term "in the possession of" is used in DET E12, excusing the taxpayer from applying s EA 3, also supports the term "possession" having a meaning with a physical focus.

37. In the Commissioner's view, to be "in the possession of" a consumable aid in terms of cl 4(d) requires the taxpayer to have actual physical possession of the consumable aid or to have it in the taxpayer's close physical control so they can use it. Legal ownership is not relevant for determining whether a person is in the possession of a consumable aid in terms of DET E12. This means, for example, that consumable aids that have been ordered and paid for but have not been delivered by the supplier at balance date are not "in the possession of" the taxpayer within DET E12 cl 4(d).

38. A further requirement of DET E12 is that it will not apply to the extent that a person has deferred the deduction of the expenditure on consumable aids to a subsequent income year for financial reporting purposes. If a taxpayer has met the other requirements of DET E12 but has deferred the deduction for some or all of the consumable aids expenditure in their financial statements, they are not able to apply DET E12 to that deferred expenditure.

39. Note that the unexpired portion of **all** expenditure on consumable aids counts towards the $58,000 threshold in DET E12. This includes any expenditure incurred on consumable aids that are not in the person's possession at balance date and expenditure on consumable aids that has been deferred to a subsequent income year in the person's financial statements.

Examples

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

Example 1: "Used up" requirement in s EA 3(4)

41. Egmont Ltd operates a tannery. It purchases different salts costing $120,000 to be used in the tannery. It also purchases fuel costing $10,000 to run the machinery used in the tanning process.

42. At the end of the income year, $60,000 worth of salts is still stored in the original containers. The other salts have been added, together with other chemicals, to different solutions in vats used in the tanning process. These brines and solutions are still being used at the end of the income year. $2,000 worth of fuel is still in the storage tank it was delivered to. There is also some fuel in the machinery tanks.

43. The salts still stored in the original containers are not used up in terms of s EA 3(4) as they continue to exist and are available beyond the income year. The expenditure on these salts is therefore unexpired and income of Egmont Ltd in that income year.

44. While the brine and solutions the other salts have been dissolved into still exist and are still used beyond the income year, the dissolved salts can be considered to be used up in terms of s EA 3(4). This is because the salts themselves do not continue to exist; rather they have been incorporated into the brines and solutions. There is no unexpired portion in relation to these salts.

45. The fuel still in the storage tank and the fuel that is still in the machinery tanks is not used up, as it continues to exist (as fuel) and is available to be used beyond the income year. The unexpired portion of fuel is income of Egmont Ltd. A reasonable estimate may be adopted to determine the amount of fuel still in the machinery.

46. DET E12 does not apply to excuse Egmont Ltd from complying with s EA 3 as the unexpired portion for all consumable aids is over the threshold of $58,000. Egmont Ltd needs to add back as income the total cost of the unexpired portion of salts and fuel.

Example 2: Home-produced consumable aids

47. Daisy Hills Ltd produces grain on its farm as stock feed for its dairy cows. It plants the grains and spreads fertilizer while the crop is growing in 2013. To harvest the grain crops, the company uses a contractor. At the end of the 2013–14 income year, Daisy Hills Ltd has grain in storage that has not been fed to its cows yet.

48. The home-grown grain to be used as stock feed for its dairy cows is a consumable aid for Daisy Hills Ltd. However, there is no unexpired portion of expenditure that needs to be added back under s EA 3. This is because the grain seeds and the fertiliser have been used up in terms of s EA 3(4) by planting and spreading. The services of the contractor harvesting the grain crops have been performed. The expenditure on the seeds, fertiliser and the contractor are deductible in the 2013–14 income year.

Example 3: Excused from complying with s EA 3 (DET E12)

49. Maclary Ltd, a hairdressing business, buys hair care products for $20,000 during the 2012–13 income year. Most of the products are used in the salon by the hairstylists. However, some of the products are sold as retail products to customers. At the end of the income year, Maclary Ltd has $6,000 worth of hair care products intended for use by the hair stylists left in the salon. There is also $800 worth of retail hair care products intended for sale to customers left in the salon. The salon does not have any other consumable aids on hand at the end of the income year and has not deferred the deduction for the expenditure on the hair care products to the subsequent income year for financial reporting purposes.

50. The hair care products for use by the stylists are consumable aids. They are used up in the performance of hairdressing services. As the threshold in DET E12 is not exceeded, the amount of $6,000 is deductible in the 2012–13 income year.

51. The retail hair care products that Maclary Ltd has for sale to customers are not consumable aids but fall under the definition of "trading stock" in s EB 2. These retail hair care products must be valued under the trading stock valuation rules in subpart EB at the end of the income year.

52. If Maclary Ltd decides in the 2013–14 income year to sell some of the hair care products ($400 worth) that were initially intended for use by the hair stylists when they were purchased during the 2012–13 income year, Maclary Ltd will need to treat those products as trading stock under subpart EB for the 2013–14 income year.

Example 4 – DET E12 threshold ($58,000)

53. Cailuna Ltd operates a paper mill. It purchases chemicals for $63,000, cleaning products for $48,000 and fuel for $52,000 during the 2012–13 income year. At the end of the income year, chemicals with a cost of $10,500, cleaning products with a cost of $40,000 and fuel with a cost of $9,000 are not used up.

54. The entire cost of the chemicals, the cleaning products and fuel is deductible in the 2012–13 income year as expenditure on consumable aids. However, because Cailuna Ltd has unused chemicals, cleaning products and fuel that in total cost $59,500, an amount greater than $58,000, s EA 3 applies. Cailuna Ltd cannot rely on DET E12. This means the unexpired portion of expenditure of $59,500 must be returned as income in the 2012–13 income year.

Example 5: Not in possession at balance date and DET E12

55. Piggeldy Ltd runs a pig farm. It purchases grain for its pigs costing $40,000 just before balance date. The grain was not delivered until a week after Piggeldy's balance date.

56. Even though Piggeldy had no other consumable aids on hand, and the unexpired portion of the grain was under the $58,000 threshold, DET E12 does not apply to excuse Piggeldy Ltd from complying with s EA 3. This is because, for DET E12 to apply to the expenditure on the grain, the grain needs to be in the possession of Piggeldy Ltd at balance date.

57. Piggeldy Ltd must return the $40,000 expenditure on the grain as income in the year in which the expenditure was incurred. However, Piggeldy Ltd is allowed a deduction for the $40,000 in the following year. Section EA 3 and DET E12 will apply again at the end of the following income year to determine whether any of the expenditure needs to be returned as income.

References

Related rulings/statements
"Consumable aids to manufacture or production – what they are and when to claim as a deduction", *Public Information Bulletin* No 51 (September 1969): 11
"Consumable aids – deductibility of cost", *Tax Information Bulletin* Vol 7, No 4 (October 1995): 13
Subject references
Income tax; Meaning of "consumable aids"; Prepayments
Legislative references
Income Tax Act 2007 – ss CH 1(2), CH 2, DA 1, DA 2, DB 50, EA 3, EB 2
Tax Administration Act 1994 – s 91AAC
Case references
Case 120 (1951) 1 CTBR (NS) 568
Case 16 (1968) 4 NZTBR 185
Case E98 (1982) 5 NZTC 59,522
Case N32 (1991) 13 NZTC 3,280
Thornton Estates Ltd v CIR (1998) 18 NZTC 13,577 (CA)

APPENDIX – LEGISLATION

Income Tax Act 2007

1. Section CH 2 provides:

CH 2 Adjustment for prepayments

When this section applies

(1) This section applies when a person has, under section EA 3 (Prepayments), an unexpired amount of expenditure at the end of an income year.

Income

(2) The unexpired amount is income of the person in the income year.

2. Sections DA 1(1) and (2) provide:

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**.

…

3. Sections DA 2(1) and (2) provide:

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**.

Private limitation

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

...

4. Section DB 50 provides:

DB 50 Adjustment for prepayments

When this section applies

(1) This section applies when a person has, under section EA 3 (Prepayments), an unexpired amount of expenditure at the end of an income year.

Deduction

(2) The person is allowed a deduction for the unexpired amount for the following income year.

Link with subpart DA

(3) This section supplements the general permission. The general limitations still apply, but not to the extent to which any relevant general limitation was overridden by a provision that initially allowed a deduction for the expenditure, whether in this Act or an earlier Act.

5. Sections EA 3(1)–(4) and (8) provide:

EA 3 Prepayments

When this section applies

(1) This section applies when—

(a) a person has been allowed a deduction for expenditure under this Act or an earlier Act; and

(b) the expenditure was not incurred on the items described in subsection (2); and

(c) some or all of the expenditure is unexpired under subsections (4) to (7) at the end of the person's income year.

Exclusions

(2) This section does not apply to expenditure incurred on—

…

(b) trading stock valued under subpart EB (Valuation of trading stock (including dealer's livestock)):

…

Unexpired portion

(3) The unexpired portion of a person's expenditure at the end of an income year—

(a) is income of the person in the income year under section CH 2 (Adjustment for prepayments); and

(b) is an amount for which the person is allowed a deduction in the following income year under section DB 50 (Adjustment for prepayments).

Unexpired portion: expenditure on goods

(4) An amount of expenditure on goods is unexpired at the end of an income year if, by the end of the income year,—

(a) the person has not used up the goods in deriving income; and

(b) the goods are not destroyed or rendered useless for the purpose of deriving income.

…

Commissioner's discretionary relief

(8) The Commissioner may excuse a person from complying with this section under section 91AAC of the Tax Administration Act 1994.

6. Sections EB 2(1), (2), (3)(g) and (h) provide:

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—

…

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

…

Exclusions

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

…

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

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

…

Determination E12

7. Clauses 2 and 4 of, and row (d) of the Schedule to, Determination E12 provide:

Determination E12: Persons excused from complying with section EA 3 of the Income Tax Act 2007

...

2 Reference

This determination is made under section 91AAC of the Tax Administration Act 1994. It determines the extent to which a person is excused from complying with section EA 3 of the Income Tax Act 2007. This determination applies for a person's income years ending on or after 1 April 2009, until this determination is cancelled by the Commissioner.

...

4 Determination

A person who, for an income year to which this determination applies, is allowed a deduction for an expenditure is excused from complying with section EA 3 of the Income Tax Act 2007 in respect of the expenditure and the income year to the extent to which-

(a) the expenditure is described by a row in column 1 of the schedule; and

(b) the unexpired portion of the expenditure and the unexpired portions of all other expenditures also described by the row do not, in total, exceed the maximum total amount specified in column 2 of the relevant row of the schedule; and

(c) the length of time between the balance date for the income year and the subsequent expiry date of the expenditure does not exceed the time period specified in column 3 of the relevant row of the schedule; and

(d) in relation to expenditure on goods specified in column 1 of rows d) and k) of the schedule, the goods are in the possession of the person at balance date; and

(e) the deduction of the expenditure has not been deferred to a subsequent income year for financial reporting purposes.

...

Schedule

Description of expenditure	Maximum total amount of unexpired portions	Time period between balance date and expiry date
Column 1	**Column 2**	**Column 3**
...		
d) payment for purchase of consumable	$58,000	unlimited

NEW LEGISLATION

This section of the *TIB* covers new legislation, changes to legislation including general and remedial amendments, and Orders in Council.

BUDGET 2014 TAX LEGISLATION

Two tax-related bills were introduced as part of Budget 2014.

The Budget Measures (Financial Support for Newborn Children) Bill, and the Budget Measures (Miscellaneous Fiscal Matters) Bill were introduced under urgency on 15 May 2014.

On 15 May 2014, at the committee of the whole House stage, the Budget Measures (Financial Support for Newborn Children) Bill was divided by Supplementary Order Paper No. 448 into the following two bills:

- the Taxation (Parental Tax Credit) Bill; and
- the Parental Leave and Employment Protection Amendment Bill (No 2).

The Budget Measures (Miscellaneous Fiscal Matters) Bill was divided by Supplementary Order Paper No. 451 into the following three bills:

- the Cheque Duty Repeal Bill;
- the Climate Change Response (Unit Restriction) Amendment Bill; and
- the Dumping and Countervailing Duties Amendment Bill.

The resulting bills received Royal assent on 19 May 2014.

The Taxation (Parental Tax Credit) Act 2014 increases the maximum amount of the parental tax credit to $220 per week, for the first 10 weeks following birth, for babies born on or after 1 April 2015. The abatement formula for the parental tax credit was also changed, so that it is abated against each dollar of family income earned, above the annual threshold, over the entire year.

The Parental Leave and Employment Protection Amendment Act 2014 extended the period of paid parental leave from 14 to 16 weeks, from 1 April 2015 and then to 18 weeks from 1 April 2016.

The Cheque Duty Repeal Act 2014 abolished cheque duty, with effect from 1 July 2014.

TAXATION (PARENTAL TAX CREDIT) ACT 2014

Sections MD 1, MD 2, MD 11 to MD 13 and MD 16 of the Income Tax Act 2007

As part of a package of financial support for families with newborns, Budget 2014 increased the amount of the parental tax credit to $220 per week and extended the payment period to 10 weeks. The abatement formula was also changed to better target the parental tax credit so that it is abated against each dollar of family income earned, above the annual threshold, over the entire year.

Key features

- The maximum amount of the parental tax credit has been increased from $150 a week to $220 a week, for babies born on or after 1 April 2015.
- The payment period for the parental tax credit has been extended from eight weeks to 10 weeks.
- The *effective* rate at which the parental tax credit is abated will increase to 21.25 cents for each additional dollar of family income over the annual threshold (currently $36,350). This better targets the parental tax credit payments to lower and middle income families.

Application date

These changes apply to parental tax credit payments made in respect of babies born on or after 1 April 2015.

Detailed analysis

Increase in amount and payment period

The parental tax credit is a special payment made as part of the Working for Families (WFF) scheme, on the birth of a newborn baby. To be eligible for the parental tax credit, families must not be entitled to income-tested benefits, certain pensions or a student allowance. Families who receive paid parental leave (PPL) payments cannot claim the parental tax credit as well.

Section MD 12 increases the maximum amount of the parental tax credit from $1,200 to $2,200 for each dependent child born on or after 1 April 2015.

Section MD 11 increases the period for which the parental tax credit is payable (the "parental entitlement period"), from the first eight weeks (56 days) following the birth of the child, to the first 10 weeks (70 days) following birth.

The maximum amount of the parental tax credit payment is reduced, on a pro-rata basis, for the number of days within the parental entitlement period for which the family does not satisfy the qualifying criteria.

The parental tax credit can be paid out in two ways:

- As a lump sum payment, included within the end-of-year assessment for WFF tax credits.
- In weekly or fortnightly instalments. Section MD 11(6) has been amended, so that instalment payments are now paid over the 10 weeks following the date on which the application for the parental tax credit is made.

Changes to the parental tax credit abatement formula

A family's WFF tax credits for a year are apportioned into various "entitlement periods". An entitlement period is an unbroken period within a tax year in which the following criteria are met:

- The applicant is the principal caregiver.
- As principal caregiver, the person must meet the qualifying criteria on each day of the entitlement period.
- There is no change in the principal caregiver's marital, civil union or de-facto relationship status.
- The child/children remain "dependent".
- The composition of the family's WFF tax credits does not change.

The birth of a newborn, which brings an entitlement to the parental tax credit, will always create a separate entitlement period during the year.

Abatement rules

The parental tax credit, the family tax credit and the in-work tax credit are currently abated at 21.25 cents in the dollar for every dollar by which the person's family scheme income exceeds the abatement threshold (currently $36,350).

The abatement calculation starts by determining the "credit abatement amount" for the full year. This credit abatement amount is then apportioned into the relevant tax credit entitlement periods within the year.

The WFF tax credit amounts for each entitlement period are reduced, in turn, by the amount of the family credit abatement apportioned to that entitlement period; the family tax credit is abated first, then the in-work tax credit and finally the parental tax credit.

Under the previous rules, the parental tax credit was abated against income arising during the 8-week parental entitlement period only. New section MD 2(3) introduces a new abatement formula for the parental tax credit, so that the credit abatement amount that is applied to the parental tax credit is calculated over the full year's income.

The new formula operates by "scaling up" the amount of the credit abatement in respect of the parental tax credit. It does this by taking the credit abatement amount for the entitlement period (the "period abatement amount") and subtracting the amount of the credit used to abate the family tax credit and the in-work tax credit for that entitlement period ("amounts used"). The resulting credit amount is then multiplied by 365 and divided by the number of days in the parental entitlement period that fall within the abatement period.

Example 1: Parental tax credit abatement formula

Nikki and Danny have one child aged 4, and a new baby, born on 1 April 2015. Danny works as an electrician earning $95,000.

Their family tax credit entitlement is $8,173, their in-work tax credit entitlement is $3,120 and they are also eligible for a parental tax credit of $2,200, before abatement, for the year to 31 March 2016.

Family scheme income	$95,000
Less abatement threshold	($36,350)
Abatement rate	*21.25%
Full year abatement	$12,463.13

Parental entitlement period = 2 April 2015 – 10 June 2015 (70 days/10 weeks)

Family credit abatement for entitlement period
= $12,463.13 × 70 ÷ 365
= $2,390.19

Family tax credit

($8,173 × 70 ÷ 365) =	$1,567.42
Less abatement	($2,390.19)
	−$822.77

In-work tax credit

($3,120 × 10 ÷ 52) =	$600.00
Less remaining abatement	($822.77)
	−$222.77

Before the parental tax credit amount is abated, the remaining credit abatement is scaled up, using the new formula at section MD 2(3):

Scaled up credit abatement for parental tax credit
= (period abatement amount – amount used) × (365 ÷ entitlement days)
= ($2,390.19 – $1,567.42 – $600.00) × (365 ÷ 70)
= $1,161.59

PTC amount	$2,200.00
Less scaled up remaining credit abatement	($1,161.59)
PTC payable	$1,038.41

PARENTAL LEAVE AND EMPLOYMENT PROTECTION AMENDMENT ACT 2014

The Parental Leave and Employment Protection Amendment Act 2014 amends the Parental Leave and Employment Protection Act 1987. The Ministry of Business, Innovation and Employment is responsible for these Acts. Inland Revenue supports the administration of the paid parental leave provisions.

Background

Women currently receive up to 14 weeks of taxpayer-funded paid parental leave. To qualify, they must have worked regularly for the same employer, or have been self-employed, for an average of 10 hours a week for at least the previous six months. Parental leave payments can be transferred to a spouse or partner.

Paid parental leave replaces the employee's earnings up to a maximum payment. The maximum weekly payment is adjusted each year to reflect increases in the average wage.

Paid parental leave can also be claimed when a person or couple adopts a child under six.

Key features

In Budget 2014, the Government announced that the period of paid parental leave will increase from 14 to 16 weeks from 1 April 2015 and then to 18 weeks from 1 April 2016.

The 16 or 18 weeks of paid parental leave will apply to an employee or self-employed person who takes paid parental leave in respect of a child if:

- The expected date of delivery of the child is on or after 1 April 2015 or 1 April 2016 respectively.
- The child is actually born on or after 1 April 2015 or 1 April 2016 respectively.
- For adopted children, if the date on which the person assumed care of the child is on or after 1 April 2015 or 1 April 2016 respectively.

Other changes to increase the flexibility and change the eligibility for the paid parental leave were also announced as part of Budget 2014. The details of these changes are currently being considered by the Ministry of Business, Innovation and Employment, and will be finalised after public consultation.

CHEQUE DUTY REPEAL ACT 2014

Sections 1 to 5 of the Cheque Duty Repeal Act 2014, sections 2, 76 to 86 and 86F of the Stamp and Cheque Duties Act 1971, sections 144 and 184A(5)(d) of the Tax Administration Act 1994

The Cheque Duty Repeal Act 2014 has abolished cheque duty, with effect from 1 July 2014. Cheque duty is no longer payable on cheques printed or supplied by a bank to its customers. Cheque duty is also no longer payable on bills of exchange for which cheque duty has not been prepaid.

Background

Cheque duty applied to bills of exchange (most commonly cheques) at a rate of 5 cents per bill of exchange. The Government recently announced, as part of Budget 2014, that cheque duty would be abolished, as:

- the duty no longer raised substantial revenue and the revenue raised was in decline; and
- cheque duty was easy to avoid, since closely substitutable transaction types (such as cash, EFTPOS, internet banking and credit card transactions) are not subject to duty. Cheque duty was therefore inefficient and had a small distortionary effect.

The application date of 1 July 2014 was chosen for the repeal because it tied into the return cycle for cheque duty purposes.

Key features

- Cheque duty is not payable on a bill of exchange drawn or made on or after 1 July 2014.
- Cheque duty is not payable by banks on cheques supplied to their customers on or after 1 July 2014.
- Cheque duty is not payable on cheques printed on or after 1 July 2014.
- Banks and printers of cheques, which were licensed under the Stamp and Cheque Duties Act 1971 for the quarter or month ended 30 June 2014, are required to file a final cheque duty return and make a final payment of cheque duty for that period by 21 July 2014.
- Cheque duty may be refunded to those that paid cheque duty as a licensed printer of cheques or as a temporary licensee, who apply in writing to Inland Revenue by 21 July 2014 for a refund of cheque duty they have paid (within the last eight years) in relation to cheques that have not been printed, or unused cheques that were destroyed before 1 July 2014.
- Banks that were licensed under section 81 of the Stamp and Cheque Duties Act 1971 during the quarter ended 30 June 2014 can claim, as a deduction from their final payment of cheque duty, an effective refund of cheque duty they have paid (within the last eight years) in relation to cheques that have not been used and were destroyed by the bank during the quarter ended 30 June 2014. This includes any cheques they sent to their customers that were defaced or spoiled before the customer used them.

Application dates

The repeal of cheque duty applies from 1 July 2014.

Despite the repeal taking effect on 1 July 2014, provisions necessary to:

- ensure that banks and printers of cheques file a final cheque duty return, together with payment, for the period ended 30 June 2014; and
- enable applications for refunds of cheque duty to be made,

remain in force until the 21 July 2014 due date for final cheque duty returns, payments and refund applications has passed. Section 5 of the Cheque Duty Repeal Act 2014 repeals these remaining compliance and refund provisions on 22 July 2014.

Detailed analysis

Removal of liability to pay cheque duty

Three groups paid cheque duty to Inland Revenue:

- licensed banks;
- licensed printers of cheques; and
- temporary licensees.

The effect of the Cheque Duty Repeal Act 2014 on each of these groups is explained below.

Licensed banks

Section 3(2) of the Cheque Duty Repeal Act 2014 cancelled the licences of banks licensed under section 81 of the Stamp and Cheque Duties Act 1971 from 1 July 2014. As a result of section 3(1) of the Cheque Duty Repeal Act 2014 repealing most of Part 6 of the Stamp and Cheque Duties Act 1971 from 1 July 2014, cheque duty is not payable on cheques a bank supplies to its customers or procures on its own behalf on or after 1 July 2014.

A bank that had its licence cancelled under section 3(2) of the Cheque Duty Repeal Act 2014 is required by section 3(4) of the Cheque Duty Repeal Act 2014 to file a final cheque duty return (IR 193) and make a final payment of cheque duty for the quarter ended 30 June 2014 by 21 July 2014.

Licensed printers of cheques

Section 3(2) of the Cheque Duty Repeal Act 2014 cancelled the licences of printers licensed under section 82 of the Stamp and Cheque Duties Act 1971 from 1 July 2014. As a result of section 3(1) of the Cheque Duty Repeal Act 2014 repealing most of Part 6 of the Stamp and Cheque Duties Act 1971 from 1 July 2014, cheque duty is not payable on cheques a printer prints for the use of its customers or on its own behalf on or after 1 July 2014.

A printer that had its licence cancelled under section 3(2) of the Cheque Duty Repeal Act 2014 is required by section 3(5) of the Cheque Duty Repeal Act 2014 to file a final cheque duty return (IR 191) and make a final payment of cheque duty (if any is payable) for the month ended 30 June 2014 by 21 July 2014.

Temporary licensees

Section 3(2) of the Cheque Duty Repeal Act 2014 cancelled all temporary licences granted under section 83 of the Stamp and Cheque Duties Act 1971 authorising the printing and use of cheques prepaid with cheque duty on 1 July 2014. A printer that held an authority to print the prepaid cheques to which such a licence related also had its authority cancelled on 1 July 2014 under section 3(2) of the Cheque Duty Repeal Act 2014.

Removal of liability when cheque duty has not been prepaid

Previously, if cheque duty had not been prepaid on a bill of exchange, the bill of exchange was required to be duly stamped (by affixing a postage stamp or stamps for the amount of cheque duty payable on the bill, cancelling each stamp, and stating on the bill the true date of cancellation) by:

- the drawer or maker of the bill, if the bill of exchange was drawn or made in New Zealand; or
- the first holder of the bill in New Zealand, for a bill of exchange drawn or made outside New Zealand.

As a result of section 3(1) of the Cheque Duty Repeal Act 2014 repealing most of Part 6 of the Stamp and Cheque Duties Act 1971 on 1 July 2014, cheque duty is not payable on a bill of exchange drawn or made in New Zealand from 1 July 2014. Also, from 1 July 2014, for a bill of exchange drawn or made outside New Zealand, cheque duty is not payable by the first holder of the bill in New Zealand before the holder further acts on the bill.

Termination of agreements for exemption from cheque duty

Previously, Inland Revenue had the power, under section 80 of the Stamp and Cheque Duties Act 1971, to enter into a written agreement with specified bodies exempting them from paying cheque duty. Instead, a sum equivalent to the cheque duty that otherwise would have been payable was required to be paid to Inland Revenue on the dates specified in the agreement.

All agreements under section 80 of the Stamp and Cheque Duties Act 1971 were terminated on 1 July 2014 by section 3(3) of the Cheque Duty Repeal Act 2014. Any sum accrued (but not yet paid) under such an agreement as at the date of termination remains payable by the date specified in the agreement.

Refunds of cheque duty

Under section 85 of the Stamp and Cheque Duties Act 1971, cheque duty may be refunded to those that paid cheque duty as a licensed printer of cheques or temporary licensee, upon application in writing to Inland Revenue's Duties Unit by 21 July 2014 for a refund of cheque duty they have paid (within the last eight years) in relation to cheques that have not been printed, or unused cheques that were destroyed before 1 July 2014. The minimum refund is $1.

Licensed banks are not able to make an application to Inland Revenue for a refund of cheque duty. Instead, when banks that were licensed during the quarter ended 30 June 2014 file their final cheque duty return (due by 21 July 2014), they will be able to deduct (from the amount of cheque duty payable for the quarter) cheque duty they have paid (within the last eight years) in relation to cheques that have not been used and were destroyed by the bank during the quarter ended 30 June 2014. This includes any cheques they sent to their customers that were defaced or spoiled before the customer used them.

Offences specific to cheque duty

The following criminal offences (and associated penalties) specific to cheque duty contained in section 144 of the Tax Administration Act 1994 were repealed on 1 July 2014 by section 4(1) of the Cheque Duty Repeal Act 2014:

- failure to comply with a provision of section 84 of the Stamp and Cheque Duties Act 1971;
- being licensed under section 83 of the Stamp and Cheque Duties Act 1971, or being a printer authorised under that section, and failing to comply with a provision of that section, or of a licence or authority granted under that section; and
- without first being licensed or authorised under Part 6 of the Stamp and Cheque Duties Act 1971 to do so, printing on a bill of exchange or bill of exchange form an inscription indicating that the cheque duty for the bill or form has been paid.

The following existing offences remain in force after 1 July 2014:

- being a bank licensed under section 81 of the Stamp and Cheque Duties Act 1971, failing to comply with a provision of that section or of any licence granted under that section; and
- being a printer licensed under section 82 of the Stamp and Cheque Duties Act 1971, failing to comply with a provision of that section or of a licence granted under that section.

However, from 1 July 2014, a bank or printer that had its licence cancelled under section 3(2) of the Cheque Duty Repeal Act 2014 on 1 July 2014 is treated under section 4(2) of the Cheque Duty Repeal Act 2014 as being licensed (under the applicable section), for the purposes of these two offences. This ensures that these two existing offences continue to apply in respect of non-compliance with the requirement for these banks and printers to file a final cheque duty return and make a final payment of cheque duty by 21 July 2014.

As they will become redundant after the 21 July 2014 due date for final cheque duty returns to be filed and payments made, the two remaining offences will be repealed on 22 July 2014 by section 5 of the Cheque Duty Repeal Act 2014.

Cheque duty repeal – questions we've been asked

Q: Now that cheque duty has been repealed, are printers of cheques required to be licensed by Inland Revenue?

A: No. The purpose of the requirement for printers to be licensed by Inland Revenue in order for them to be allowed to print cheques prepaid with cheque duty was to protect the integrity of the collection of cheque duty. Now that cheque duty has been repealed, this need for Inland Revenue to administer a licensing regime for printers of cheques no longer exists. If the licensing regime provided any other benefits, these were purely incidental.

ORDERS IN COUNCIL

INCOME TAX (FRINGE BENEFIT TAX, INTEREST ON LOANS) AMENDMENT REGULATIONS 2014

The prescribed rate of interest used to calculate fringe benefit tax on low-interest, employment-related loans is 6.13%, up from the previous rate of 5.90% which applied from the quarter beginning 1 April 2011.

The new rate applies from the quarter beginning 1 July 2014. The rate is reviewed regularly to align it with the results of the Reserve Bank's survey of variable first-mortgage housing rates.

The new rate was set by Order in Council on 29 May 2014.

Income Tax (Fringe Benefit Tax, Interest on Loans) Amendment Regulations 2014 (SR 2014/183)

PRIVACY (INFORMATION SHARING AGREEMENT BETWEEN INLAND REVENUE AND NEW ZEALAND POLICE) ORDER 2014

The Privacy (Information Sharing Agreement between Inland Revenue and New Zealand Police) Order 2014 approves a new information-sharing agreement between Inland Revenue and the New Zealand Police. Under the agreement, Inland Revenue will be able to share personal information with the New Zealand Police for the prevention, detection, investigation of, or use as evidence of, a serious crime.

Information will only be shared when:

- the New Zealand Police (if requesting) or Inland Revenue (if proactively sharing) has reasonable grounds to suspect that a serious crime has been, is being, or will be, committed;
- the New Zealand Police (if requesting) or Inland Revenue (if proactively sharing) has reasonable grounds to suspect that the personal information is relevant to the prevention, detection or investigation of, or is evidence of, a serious crime;
- Inland Revenue determines that the personal information is readily available within Inland Revenue and that it is reasonable, practicable and in the public interest to provide the personal information to the New Zealand Police; and
- in relation to serious crimes, being those punishable by at least four years' imprisonment.

The objectives of the agreement are to:

- reduce the level of serious crimes;
- gain efficiencies through more collaborative, cross-agency work; and
- ensure sufficient protection of people's privacy and a proper level of security and transparency.

The Privacy Act 1993 provides a mechanism for the approval by Order in Council of information-sharing agreements between agencies. This is the second information-sharing agreement approved in accordance with Part 9A of the Act.[1]

What information will be shared?

The agreement allows for information to be shared when the four-step test outlined above is met. Information able to be shared between the New Zealand Police and Inland Revenue includes:

- Information about an individual's associates
- Tax information
- Financial transaction information
- Financial relationship information
- Domestic relationship information
- Information about assets
- Employment information
- Person records (names, dates of birth, contact details and family members)
- Social assistance information.

How will the information be used?

Information provided by Inland Revenue will be used by the New Zealand Police for the prevention, detection, investigation of, or to use as evidence of, serious crimes.

What actions may result from the New Zealand Police receiving information shared under the agreement?

The New Zealand Police can be expected to take law enforcement action as a result of information shared under the agreement, including investigating a suspected serious crime, and arresting or prosecuting people suspected of having committed a serious crime.

The regulations apply from 26 June 2014.

The agreement can be found at **www.ird.govt.nz** or **www.police.govt.nz**

Privacy (Information Sharing Agreement Between Inland Revenue and New Zealand Police) Order 2014 (LI 2014/184)

[1] The first information-sharing agreement, *Privacy (Information Sharing Agreement Between Inland Revenue and Internal Affairs) Order 2013*, came into force 3 October 2013.

OPERATIONAL STATEMENTS

Operational statements set out the Commissioner's view of the law in respect of the matter discussed. They are intended to be a preliminary view in the absence of a public binding ruling or an interpretation statement on the subject.

2014 REVIEW OF THE COMMISSIONER'S MILEAGE RATE FOR EXPENDITURE INCURRED FOR THE BUSINESS USE OF A MOTOR VEHICLE

Operational Statement 09/01 published in the *Tax Information Bulletin* Vol 21, No 3 (May 2009) provides the Commissioner's statement of a mileage rate for expenditure incurred for the business use of a motor vehicle (OS 09/01 can be viewed at the Inland Revenue **website www.ird.govt.nz/technical-tax/op-statements/**). This Operational Statement provides that the Commissioner will review mileage rate on a yearly basis.

A recent review of the Commissioner's mileage rate, confirms the rate will remain at 77 cents per kilometre for both petrol and diesel fuel vehicles for the 2014 income year. The weighted average rate of 76.45478 cents per kilometre is calculated for the 2014 income year, compared to a weighted average of 76.32516 for the 2013 income year. The 2014 income year for business taxpayers with a standard 31 March balance date, generally runs from 1 April 2013 to 31 March 2014.

The Commissioner is required by statute to set a mileage rate for persons whose business travel is 5,000 or less in an income year. The mileage rate is set retrospectively for persons required to file a return for business income, so that the rate reflects the average motor vehicle operating costs for an income year. Those persons who meet the criteria have a choice of using the Commissioner's mileage rate or use actual costs if they consider that the Commissioner's mileage rate does not reflect their true costs. Taxpayers that choose to use actual costs are required to keep records to support any expenditure claimed.

The Commissioner accepts that employers may use the 2014 vehicle mileage rate as a reasonable estimate of costs when they reimburse employees for the use of their private vehicle for business related travel for a current income year (post 1 April 2014).

Also, employers may use an alternative estimate other than the Commissioner's vehicle mileage rate when reimbursing employees for use of their private vehicle for employment related use. It is accepted that employers may use the motor vehicle running cost data published by other reputable sources, for example the New Zealand Automobile Association Incorporated, as an alternative reasonable estimate for reimbursement of employees.

The mileage rate does not apply in respect of motor cycles.

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 14/04: INCOME TAX – DEPRECIATION ROLL-OVER RELIEF FOR CANTERBURY

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

This Question We've Been Asked is about s EZ 23B.

Question

1. How does the formula in s EZ 23B(4) allocate the excess recovery amount when an item of affected property is replaced with one or more items of replacement property?

Answer

2. The formula determines how much of the excess recovery amount is to be allocated against the cost of a particular replacement item. It does this with reference to the accumulated cost of **other** items of replacement property acquired before the particular replacement item (ss EZ 23B(4) and EZ 23B(5)). This means that where only one replacement item is acquired, the cost of other items of replacement property acquired before the particular replacement item is zero.
3. Since the focus of this Question We've Been Asked is on the application and effect of the formula, it supplements the comprehensive analysis of s EZ 23B in "Canterbury earthquake relief measures" *Tax Information Bulletin* Vol 23, No 8 (October 2011) at 66–68.
4. The formula in s EZ 23B(4) applies to affected property not depreciated in a pool. Therefore, the scope of this Question We've Been Asked is limited to those classes of affected property not depreciated in a pool.

Explanation

5. Section EZ 23B provides roll-over relief in respect of depreciation recovery income for taxpayers affected by the Canterbury earthquakes. It applies when a person receives insurance or compensation that gives rise to depreciation recovery income for items of depreciable property (called the affected property) lost or irreparably damaged in the Canterbury earthquakes (s EZ 23B(1)). Provided certain conditions are met, the amount that would be depreciation recovery income is available to be allocated against the cost of replacement items (ss EZ 23B(2) and EZ 23B(3)). Any amount of depreciation recovery income not allocated to replacement items by the end of the 2018–19 income year at the latest is taxable as depreciation recovery income (ss EZ 23B(2B) and EZ 23B(8)).
6. This Question We've Been Asked clarifies the effect of the formula in s EZ 23B(4). The formula calculates the amount of the depreciation recovery income that can be allocated against the cost of the replacement property. There has been some confusion about how the formula works. The confusion appears to arise because one of the items in the formula uses the expenditure incurred in acquiring **other** items of replacement property instead of using the expenditure in acquiring the particular item of replacement property. This is necessary to ensure that the depreciation recovery income is not over-allocated to the particular replacement item.
7. The purpose of the depreciation roll-over relief provisions (s EZ 23B) is to provide affected taxpayers with options in relation to the potential tax liability on the depreciation recovery income arising from the insurance or compensation received. In addition to the option of simply returning the depreciation recovery income, taxpayers can elect to use the depreciation roll-over relief provisions. This election gives taxpayers the further option to defer or "suspend" the recognition of the depreciation recovery income to a later income year (with the latest income year being the 2018–19 income year) or to suspend and "roll-over" the depreciation recovery income into the cost of the replacement item.
8. The formula progressively allocates the depreciation recovery amount to each item of replacement property as it is acquired (ie, on a "first-in-first-served" basis) until the total cost of the replacement item or items equals or is more than the cost of the affected class (s EZ 23B(4)). It works in the same way where multiple replacement items are acquired at the same time, because the items are treated as having been acquired in the order chosen by the person (s EZ 23B(11C)).

9. The effect of the formula is to roll-over into the cost of the replacement item or items all of the depreciation recovery arising from insurance or compensation received if the total cost of the replacement item or items equals or is more than the cost of the affected class (s EZ 23B(4)).
10. If, on the other hand, the total cost of all replacement items is less than the cost of the affected class, only a proportion of the depreciation recovery amount can be rolled-over into the cost of the replacement items. The balance of the depreciation recovered is recognised as income at or before the end of the 2018–19 income year (ss EZ 23B(2B) and EZ 23B(8)).
11. Any amount rolled-over to a replacement item reduces the adjusted tax value of the replacement item (ss EZ 23B(3)(a) and EZ 23B(11)). This means that when the replacement item is eventually sold, the amount that was rolled-over to the replacement item will be fully taxable as depreciation recovery income provided the replacement item is sold for more than its adjusted tax value. The tax liability associated with disposal of the affected property has effectively been rolled forward until disposal of the replacement property.
12. If the affected property is not actually replaced, then any depreciation recovery income arising from the insurance or compensation received is brought into account as income in the earlier of:
    - the 2018–19 income year (s EZ 23B(8)(a));
    - the income year in which the person decides not to purchase more replacement property (s EZ 23B(8)(b)); or
    - the income year in which the person goes into liquidation or bankruptcy (s EZ 23B(8)(c)).

How the formula works

13. The formula applies to the following groups or classes of affected property:
    - a building or grandparented structure (not depreciated in a pool) (s EZ 23B(10)(b)(i));
    - commercial fit-out (not depreciated in a pool) (s EZ 23B(10)(b)(ii));
    - other depreciable property (not depreciated in a pool) (s EZ 23B(10)(b)(iv)).
14. The following steps must be taken for each of these affected classes of depreciable property:

    Step 1: Calculate the depreciation recovery income.

    Step 2: Calculate, using the formula, the amount (called the reduction amount for the purposes of this Question We've Been Asked) to be used for both:
    - allocating against the cost of the replacement item; and
    - reducing the amount of suspended recovery income.

    Step 3: Reduce the adjusted tax value of the replacement item by the reduction amount.

    Step 4: Reduce the suspended recovery income by the reduction amount.

    Repeat steps 2–4, if more than one replacement item is purchased.

    Step 5: Return any unallocated suspended recovery income as depreciation recovery income.

Examples demonstrating how the formula works

15. The following three examples demonstrate how the formula works using the steps set out above. Examples 1 and 2 apply the formula to different scenarios where only one replacement item is acquired. Example 3 applies the formula to the situation where multiple replacement items are acquired.

Example 1: Acquisition of a replacement building costing more than the destroyed building

16. Tom receives insurance proceeds of $10 million for a building destroyed in a Canterbury earthquake. The original cost of the building was $10 million and its adjusted tax value was $9 million. Tom plans to acquire a replacement building costing $12 million.

17. Because the cost of the replacement building is equal to or greater than the cost of the affected property, the whole excess recovery amount should be available to be rolled-over against the cost of the replacement building.

Step 1: Calculate the excess recovery

18. The insurance proceeds exceed the building's adjusted tax value by $1 million. Therefore, Tom has an excess recovery of $1 million.

Step 2: Calculate the reduction amount

19. Tom now has to calculate the reduction amount by applying the following formula:

$$\frac{\text{limited replacement cost} \times \text{excess}}{\text{affected cost}}$$

20. The limited replacement cost is the lesser of:
    i) the amount by which the cost of the affected class (in this example, the destroyed building) exceeds the total expenditure in acquiring other replacement property before the replacement item; or
    ii) the amount spent on the replacement item.

21. The affected cost is the total cost of the destroyed building.

22. No other replacement property has been acquired before the $12 million replacement building. Therefore, the amount under (i) above is:

    $10 million – $0 = $10 million

23. The amount spent on the replacement building under (ii) above is $12 million.

24. As the limited replacement cost is the lesser of these two amounts, the "limited replacement cost" is $10 million. The reduction amount can now be calculated using the following amounts in the above formula:

$$\frac{\$10 \text{ million} \times \$1 \text{ million}}{\$10 \text{ million}} = \$1 \text{ million}$$

Step 3: Reduce the adjusted tax value of the replacement item by the reduction amount

25. The reduction amount of $1 million is now available to roll-over into the adjusted tax value of the replacement building as follows:

    $12 million (cost of replacement property)
    – $1 million (the reduction amount)
    = $11 million (adjusted tax value)

Step 4: Reduce the excess recovery by the reduction amount

26. The reduction amount of $1 million is now also available to reduce the excess recovery:

    $1 million (excess recovery) – $1 million (the reduction amount) = $0

27. Any amount remaining after reducing the excess recovery now becomes the suspended recovery income.

Step 5: Return any unallocated suspended recovery income as depreciation recovery income

28. Since the excess recovery has been reduced to zero, Tom has no liability to return any unallocated suspended recovery income.

Summary of example 1

29. In this example, the depreciation roll-over relief provisions act to:
    a) fully allocate the depreciation recovery income of $1 million against the cost of the first and, in this example, the only replacement building, because its cost is greater than the cost of the destroyed building;
    b) reduce the adjusted tax value of the replacement building to $11 million;
    c) defer the recognition of depreciation recovery income of $1 million until the subsequent sale of the replacement building (assuming the building is sold for more than its adjusted tax value).

Example 2: Acquisition of a replacement building costing less than the destroyed building

30. Kiwico Ltd receives insurance proceeds of $20 million for a building destroyed in a Canterbury earthquake. The original cost of the building was $20 million and its adjusted tax value was $18 million. Kiwico Ltd plans to acquire a replacement building costing $15 million.

31. Because the cost of the replacement building is less than the cost of the affected property, only some of the excess recovery amount can be allocated against the cost of the replacement building.

Step 1: Calculate the excess recovery

32. The insurance proceeds exceed the building's adjusted tax value by $2 million. Therefore, Kiwico Ltd has an excess recovery of $2 million.

Step 2: Calculate the reduction amount

33. Kiwico Ltd now has to calculate the reduction amount by applying the following formula:

$$\frac{\text{limited replacement cost} \times \text{excess}}{\text{affected cost}}$$

34. The limited replacement cost is the lesser of:
    i) the amount by which the cost of the affected class (in this example, the destroyed building) exceeds the total expenditure in acquiring other replacement property before the replacement item; or
    ii) the amount spent on the replacement item.

35. The affected cost is the total cost of the destroyed building.

36. No other replacement property has been acquired before the $15 million replacement building. Therefore, the amount under (i) above is:

    $20 million – $0 = $20 million

37. The amount spent on the replacement building under (ii) above is $15 million.

38. As the limited replacement cost is the lesser of these two amounts, the "limited replacement cost" is $15 million. The reduction amount can now be calculated using the following amounts in the above formula:

$$\frac{\$15 \text{ million} \times \$2 \text{ million}}{\$20 \text{ million}} = \$1.5 \text{ million}$$

Step 3: Reduce the adjusted tax value of the replacement item by the reduction amount

39. The reduction amount of $1.5 million is now available to roll-over into the cost of the replacement building:

    $15 million (cost of replacement property)
    – $1.5 million (the reduction amount)
    = $13.5 million (adjusted tax value)

Step 4: Reduce the excess recovery by the reduction amount

40. The reduction amount of $1.5 million is now also available to reduce the excess recovery:

    $2 million (excess recovery) – $1.5 million (the reduction amount) = $500,000

41. The suspended recovery income is now the reduced amount of $500,000.

Step 5: Return any unallocated suspended recovery income as depreciation recovery income

42. The unallocated suspended recovery income of $500,000 must be returned as depreciation recovery income in the income year in which Kiwico Ltd decides not to acquire any more replacement property in this class, goes into liquidation, or at the end of the 2018–19 income year (whichever comes first).

Summary of example 2

43. In this example, the depreciation roll-over relief provisions act to:
    a) roll-over $1.5 million of the depreciation recovery income of $2 million into the cost of the replacement building;
    b) reduce the adjusted tax value of the replacement building to $13.5 million;
    c) defer the recognition of the suspended recovery income of $500,000 to the income year in which Kiwico Ltd decides not to acquire any more replacement property in this class, goes into liquidation, or the end of the 2018–19 income year (whichever comes first);
    d) defer the recognition of the depreciation recovery income of $1.5 million until the subsequent sale of the replacement building (assuming the building is sold for more than its adjusted tax value).

Example 3: Multiple replacement items

44. The following example demonstrates how the formula works where more than one item of replacement property is acquired.

45. Linda receives insurance proceeds of $1 million for plant and equipment (not previously depreciated under the pool method) destroyed in a Canterbury earthquake. The original cost of the plant and equipment was $1 million and its adjusted tax value was $700,000. Linda is not required to replace items of affected property "like for like" as long as the affected property is not a building or grandparented structure, or commercial fit-out. She acquires the following replacement items:

- Year 1: plant and equipment costing $400,000;
- Year 2: an overhead crane costing $400,000;
- Year 3: a digger costing $400,000;
- Year 4: plant and equipment costing $10,000.

Step 1: Calculate the excess recovery

46. The insurance proceeds exceed the adjusted tax value of the plant and equipment by $300,000. Therefore, Linda has an excess recovery of $300,000.

Year 1 – Step 2: Calculate the reduction amount

47. Linda now has to calculate the reduction amount for year 1 by applying the following formula:

$$\frac{\text{limited replacement cost} \times \text{excess}}{\text{affected cost}}$$

48. The limited replacement cost is the lesser of:

    i) the amount by which the cost of the affected class (in this example, the destroyed plant and equipment) exceeds the total expenditure in acquiring other replacement property before the replacement item; or

    ii) the amount spent on the replacement item.

49. The affected cost is the total cost of the destroyed plant and equipment.

50. No other replacement property has been acquired before the first replacement item of plant and equipment of $400,000. Therefore, the amount under (i) above is:

    $1 million – $0 = $1 million

51. The amount spent on the replacement plant and equipment under (ii) above is $400,000.

52. This means the "limited replacement cost" is $400,000. The reduction amount for year 1 can now be calculated using the following amounts in the above formula:

$$\frac{\$400{,}000 \times \$300{,}000}{\$1 \text{ million}} = \$120{,}000$$

Year 1 – Step 3: Reduce the adjusted tax value of the replacement item by the reduction amount

53. The reduction amount of $120,000 is now available to roll-over into the adjusted tax value of the replacement plant and equipment:

    $400,000 (cost of replacement property)
    – $120,000 (the reduction amount)
    = $280,000 (adjusted tax value)

Year 1 – Step 4: Reduce the excess recovery by the reduction amount

54. The reduction amount of $120,000 is now also available to reduce the excess recovery:

    $300,000 (excess recovery) – $120,000 (the reduction amount) = $180,000

55. The suspended recovery income is now the reduced amount of $180,000.

Year 2 – Step 2: Calculate the reduction amount

56. For year 2, Linda applies the formula as follows.

57. Total expenditure in acquiring other replacement property before the second replacement item is $400,000 (being the cost of the first replacement item of plant and equipment). Therefore, the amount under (i) above is:

    $1 million – $400,000 = $600,000

58. The amount spent on the replacement overhead crane in year 2 under (ii) above is $400,000.

59. This means the "limited replacement cost" is $400,000 (the lesser of $600,000 calculated under (i) and $400,000 calculated under (ii)). The reduction amount for year 2 can now be calculated using the formula:

$$\frac{\$400{,}000 \times \$300{,}000}{\$1 \text{ million}} = \$120{,}000$$

Year 2 – Step 3: Reduce the adjusted tax value of the replacement item by the reduction amount

60. The reduction amount of $120,000 is now available to roll-over into the adjusted tax value of the replacement overhead crane:

    $400,000 (cost of replacement property)
    – $120,000 (the reduction amount)
    = $280,000 (adjusted tax value)

Year 2 – Step 4: Reduce the suspended recovery income by the reduction amount

61. The reduction amount of $120,000 is now also available to reduce the suspended recovery income:

$180,000 (suspended recovery income as reduced in year 1) – $120,000 (the reduction amount) = $60,000

62. The suspended recovery income is now reduced further to $60,000.

Year 3 – Step 2: Calculate the reduction amount

63. For year 3, Linda applies the formula as follows.

64. Total expenditure in acquiring other replacement property before the third replacement item is $800,000 ($400,000 for each of the plant and equipment and the overhead crane). Therefore, the amount under (i) above is:

$1 million – $800,000 = $200,000

65. The amount spent on the replacement digger in year 3 under (ii) above is $400,000.

66. This means the "limited replacement cost" is $200,000 (the lesser of $200,000 calculated under (i) and $400,000 calculated under (ii)). The reduction amount for year 3 can now be calculated using the formula:

$$\frac{\$200{,}000 \times \$300{,}000}{\$1 \text{ million}} = \$60{,}000$$

Year 3 – Step 3: Reduce the adjusted tax value of the replacement item by the reduction amount

67. The reduction amount of $60,000 is now available to roll-over into the adjusted tax value of the replacement digger:

$400,000 (cost of replacement property) – $60,000 = $340,000 adjusted tax value

Year 3 – Step 4: Reduce the suspended recovery income by the reduction amount

68. The reduction amount of $60,000 is now also available to reduce the suspended recovery income:

$60,000 (suspended recovery income as reduced in year 2) – $60,000 = $0

69. At the end of year 3, the combined cost of the replacement items is reduced by a total of $300,000 from $1.2 million to $900,000. Therefore, the depreciation recovery income of $300,000 is fully rolled into the cost of the replacement property, which reduces the adjusted tax value for depreciation purposes. This is what would be expected, because the total cost of the replacement items exceeds the cost of the affected property.

Year 4

70. Because the cost of other replacement items ($1.2 million, being $400,000 in each of years 1–3) exceeds the cost of the affected property ($1 million) no further reductions are available (s EZ 23B(4)(a)). This makes sense because the full amount of the excess recovery has already been allocated against replacement items.

Step 5: Return any unallocated suspended recovery income as depreciation recovery income

71. Since the suspended recovery income has been reduced to zero, Linda has no liability to return any unallocated suspended recovery income.

Summary of example 3

72. In this example, the depreciation roll-over relief provisions act to:

a) fully allocate the depreciation recovery income of $300,000 against the cost of the replacement items purchased in years 1–3, on a first-in-first-served basis;

b) reduce the adjusted tax values of the replacement items from $1.2 million to $900,000.

73. The same result would be achieved had Linda purchased all the replacement items at the same time but chose to treat them in her income tax return as being acquired in the same order as in this example.

Other requirements for depreciation roll-over relief

74. To qualify for the depreciation roll-over relief, the replacement asset must be:

- acquired before the end of the 2018–19 income year (s EZ 23B(1)); and
- depreciable property (that is not depreciable intangible property) (s EZ 23B(1)(a)(i)); and
- in the same category as the affected property if the affected property is a building or grandparented structure, or commercial fit-out (s EZ 23B(7)).

75. In addition, any replacement building or grandparented structure, or commercial fit-out must be located in greater Christchurch (s EZ 23B(7)).

76. Taxpayers who wish to make use of the depreciation roll-over relief provisions must elect to do so by giving written notice to the Commissioner specifying the affected property and linking each item of replacement property with an affected class. This notice must be given by the later of 31 January 2012 or when the income tax return is filed for the income year in which the insurance pay-out can be reasonably estimated. Written notice must also be given in each

subsequent year in which the depreciation recovery income is suspended (ss EZ 23B(1)(f) and EZ 23B(9)).

The Commissioner's operational approach

77. The Commissioner recognises that taxpayers may have incorrectly applied the formula under s EZ 23B(4) in their calculation of the reduction amount as a result of the interpretive uncertainty discussed in this Question We've Been Asked. In some cases, the application of the formula has produced incorrect results because of the uncertainty clarified in the Taxation (Annual Rates, Foreign Superannuation, and Remedial Matters) Act 2014 enacted on 27 February 2014 regarding when multiple items of replacement property are acquired at the same time.

78. Where, for one of the reasons set out above, the application of the formula has resulted or will result in an overpayment of income tax, taxpayers can request Inland Revenue amend their assessment under s 113 of the Tax Administration Act 1994. The Commissioner will apply the principles set out in the Standard Practice Statement "SPS 07/03 Requests to amend assessments" *Tax Information Bulletin* Vol 19, No 5 (June 2007) at 8 (or any replacement) on a case by case basis to determine whether to amend assessments.

79. If, for one of the reasons set out above, the application of the formula has resulted or will result in an underpayment of income tax, the Commissioner will not actively apply her resources to seek to amend assessments. This approach applies only to the application of the formula in relation to returns filed prior to the publication of this Question We've Been Asked.

80. In other cases of underpayment, the Commissioner's normal approach will apply.

81. Taxpayers should ensure that they apply the formula correctly from the date of publication of this Question We've Been Asked (including in respect of previous periods for which a return is yet to be filed).

References

Subject references
Income tax; Depreciation; Depreciation roll-over relief; Canterbury earthquakes
Legislative references
Income Tax Act 2007 – s EZ 23B
Related rulings/statements
"Canterbury earthquake relief measures" *Tax Information Bulletin* Vol 23, No 8 (October 2011)
"SPS 07/03 Requests to amend assessments" *Tax Information Bulletin* Vol 19, No 5 (June 2007)

QB 14/05: INCOME TAX – ASC RULES – CALCULATING THE "SUBSCRIPTIONS" AMOUNT FOR AN AMALGAMATED COMPANY WHEN THE SHARES OF AN AMALGAMATING COMPANY ARE HELD BY ANOTHER AMALGAMATING COMPANY

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

This Question We've Been Asked is about s CD 43(15)(a)(ii).

Question

1. We have been asked whether s CD 43(15)(a)(ii) excludes an amount equal to the consideration received for shares issued by an amalgamating company that are directly or indirectly held by another amalgamating company from the "subscriptions" amount for an amalgamated company in the available subscribed capital (ASC) formula in s CD 43(1).

Answer

2. Yes. An amount equal to the consideration received for shares issued by an amalgamating company that are held directly or indirectly by another amalgamating company is excluded from the amalgamated company's subscriptions amount by s CD 43(15)(a)(ii).
3. For an amalgamated company, as with any other company, the "subscriptions" amount in the ASC formula is the consideration received for shares issued, under the definition of "subscriptions" in s CD 43(2)(b). Section CD 43(15) adds an additional amount to the "subscriptions" amount of an amalgamated company. Section CD 43(15) provides that the "subscriptions" amount of an amalgamated company includes an amount equal to the ASC of all shares in the amalgamating companies except:
   - shares in the amalgamating companies that are held (directly or indirectly) by another amalgamating company (s CD 43(15)(a)(ii)); and
   - shares in the amalgamated company (s CD 43(15)(a)(iii)).
4. Section CD 43(15)(a)(ii) operates to prevent the counting of the ASC of shares in an amalgamating company if those shares are held by another amalgamating company.
5. The purpose of the ASC formula is to determine the amount that shareholders have paid into a company as capital when subscribing for shares. The ASC of a company can be returned to shareholders tax-free in certain circumstances rather than being treated as a dividend. The reason for excluding the ASC of subsidiaries from this calculation is to avoid the double-counting of capital that has been introduced by the underlying shareholders.
6. This question arose following a previous QWBA ("QB 13/02: Income tax – Determining the "subscriptions" amount for an amalgamated company under the available subscribed capital rules") published in *Tax Information Bulletin* Vol 25, No 6 (July 2013): 50. This QWBA should be read in conjunction with QB 13/02.

Explanation

7. This Question We've Been Asked clarifies the effect of s CD 43(15)(a)(ii), following the publication of QB 13/02.
8. It had been suggested that the conclusion reached in QB 13/02 indicated that the subscriptions amount of an amalgamated company included the ASC of the shares in all amalgamating companies (other than the amalgamated company). The purpose of this QWBA is to clarify that the ASC of an amalgamated company includes the ASC of the shares in all amalgamating companies other than those shares listed in both ss CD 43(15)(a)(ii) and (iii).

Section CD 43(2)(b)

9. Sections CD 43(1) and (2) provide:

> **CD 43 Available subscribed capital (ASC) amount**
>
> *Formula for calculating amount of available subscribed capital*
>
> (1) For a share (the **share**) in a company at any relevant time (the **calculation time**), the amount of **available subscribed capital** is calculated using the formula—
>
> 1 July 1994 balance + subscriptions − returns − look-through company returns.
>
> *Definition of items in formula*
>
> (2) In the formula in subsection (1),—
>
> (a) **1 July 1994 balance** is,—
>
> (i) if the company existed before 1 July 1994, the amount calculated under subsection (3); and
>
> (ii) in any other case, zero:
>
> (b) **subscriptions**, subject to subsections (6) to (21), is the total amount of consideration that the company received, after 30 June 1994 and before the calculation time, for the issue of shares of the same class (the class)

QUESTIONS WE'VE BEEN ASKED

as the share, ignoring section HB 1 (Look-through companies are transparent):

(c) **returns**, subject to subsections (22) and (23), is the total amount of consideration that the company paid, after 30 June 1994 and before the calculation time, on the cancellation of shares in the relevant class and that was not a dividend because of section CD 22 or CD 24 or a corresponding provision of an earlier Act:

(d) **look-through company returns** is the total amount of consideration that the company paid, before the calculation time, on the cancellation or buyback of shares in the relevant class while the company was a look-through company, ignoring section HB 1.

10. This QWBA only considers the "subscriptions" amount in the formula. Section CD 43(2)(b) provides that the subscriptions amount of a company is the total amount of consideration that the company received, after 30 June 1994 and before the calculation time, for the issue of shares of the same class.

11. Section CD 43(2)(b) is subject to s CD 43(15) when determining the subscriptions amount of an amalgamated company.

Section CD 43(15)

12. Section CD 43(15) provides:

Subscriptions amount: amalgamated company

(15) The subscriptions amount for a company that is an amalgamated company resulting from an amalgamation—

(a) includes an amount, as if it were consideration received at the time of the amalgamation for the issue of the amalgamated company's shares, equal to the available subscribed capital, at the time of the amalgamation, of all shares in the amalgamating companies that are—

(i) of an equivalent class to the class; and

(ii) not held directly or indirectly by an amalgamating company; and

(iii) not shares in the amalgamated company:

(b) does not include any other amount for the agreement of shareholders of an amalgamating company to the amalgamation and the resulting property acquisitions by the amalgamated company.

13. Section CD 43(15) applies to a company that is an amalgamated company. An "amalgamated company" is defined in s YA 1 as the one company that results from and continues after an amalgamation and it may be one of the amalgamating companies or a new company. "Amalgamating company" is a company that amalgamates with one or more other companies under an amalgamation. Therefore, all companies involved in an amalgamation are amalgamating companies. A company that exists before an amalgamation and continues as the amalgamated company is both the "amalgamated company" and an "amalgamating company".

14. Section CD 43(15) includes an amount (as if it were consideration received at the time of the amalgamation for the issue of the amalgamated company's shares) equal to the ASC of all shares of the same class in the amalgamating companies. This amount, however, does not include:

- the ASC of shares in an amalgamating company that are held by an amalgamating company (s CD 43(15)(a)(ii)); and
- the ASC of shares in the amalgamated company (s CD 43(15)(a)(iii)). This is because the ASC of the shares in the amalgamated company is already included in the "subscriptions" amount in s CD 43(2)(b). See QB 13/2 for further clarification of this point.

15. It is further noted that s CD 43(15)(b) provides that the subscriptions amount also does not include any amounts for the agreement of shareholders to the amalgamation and the resulting property acquisitions by the amalgamated company.

16. Under s CD 43(15)(a)(ii), the shares of any subsidiaries of the amalgamating companies (including the company that becomes the amalgamated company) are not included in the calculation of the amalgamated company's subscriptions amount.

17. By reading ss CD 43(2)(b) and (15) together, it can be seen that the subscriptions amount of an amalgamated company equals the amount under s CD 43(2)(b) plus the ASC of the shares of all the amalgamating companies other than the amalgamated company and any amalgamating companies that are subsidiaries of other amalgamating companies.

18. The reason for excluding the ASC of subsidiaries from this calculation is to avoid the double-counting of capital that has been introduced by the underlying shareholders. This is because the underlying shareholders have only subscribed for the shares in the parent company, and so that ASC value should only be included once. Otherwise it could be possible for shareholders to create extra ASC through capitalising subsidiaries, and increasing their ASC on an amalgamation.

19. We note that this item only concerns the "subscriptions" component of the formula for calculating an amalgamated company's ASC. Other components of the formula, such as the "returns" amount, may be relevant in certain situations (eg, where there is a cancellation of shares under s CD 43(24)).

Conclusion

20. The Commissioner considers that the subscriptions amount of an amalgamated company includes the amalgamated company's ASC, as well as an additional amount that is equal to the ASC of all shares in the amalgamating companies that are of an equivalent class, except:
    - shares in the amalgamated company (as that ASC is already counted), and
    - the shares of any amalgamating companies that are held by other amalgamating companies.

Examples

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

Example 1: Vertical Amalgamation

- A Co Ltd was incorporated in December 2012 and issued 2,000 ordinary shares for $1 each.
- B Co Ltd was incorporated in December 2012 and issued 1,000 ordinary shares to A Co Ltd for $1 each.
- C Co Ltd was incorporated in December 2012 and issued 1,000 ordinary shares to B Co Ltd for $1 each.

22. The three companies amalgamated in March 2013. A Co Ltd remains as the amalgamated company.

23. The ASC of the amalgamated company is calculated using the following formula:

    1 July 1994 balance + subscriptions – returns – look-through company returns

24. The subscriptions amount is determined under ss CD 43(2)(b) and CD 43(15). Based on the interpretation in this QWBA and in QB 13/02, the subscriptions amount equals the subscriptions of the amalgamated company under s CD 43(2)(b) plus the subscriptions of the amalgamating companies under s CD 43(15). However, ss CD 43(15)(a)(ii) and (iii) exclude the subscriptions of any subsidiaries and of the amalgamated company from being counted.

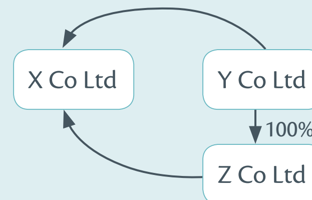
25. The ASC of A Co Ltd is calculated as follows:

    0 + (subscriptions of A Co Ltd of 2,000) – 0 – 0
    = 2,000 ASC

Example 2: Horizontal Amalgamation

- X Co Ltd was incorporated in December 2012 and issued 2,000 ordinary shares for $1 each.
- Y Co Ltd was incorporated in December 2012 and issued 1,000 ordinary shares for $1 each.
- Z Co Ltd was incorporated in December 2012 and issued 1,000 ordinary shares to Y Co Ltd for $1 each.

26. The three companies amalgamated in March 2013. X Co Ltd remains as the amalgamated company.



27. The subscriptions amount is determined under ss CD 43(2)(b) and CD 43(15). Based on the interpretation in this QWBA and in QB 13/02, the subscriptions amount equals the subscriptions of the amalgamated company under s CD 43(2)(b) plus the subscriptions of the amalgamating companies under s CD 43(15). However, ss CD 43(15)(a)(ii) and (iii) exclude the subscriptions of any subsidiaries and of the amalgamated company from being counted.

28. The ASC of X Co Ltd is calculated as follows:

    0 + (subscriptions of X Co Ltd of 2,000 + subscriptions of Y Co Ltd of 1,000) – 0 – 0
    = 3,000 ASC

29. The question asked and the above analysis and examples only need to be concerned with the calculation of the "subscriptions" amount for determining the ASC of an amalgamated company. In some amalgamations the other items in the ASC formula will also be relevant. For example, the "returns" amount in the formula requires a subtraction of the amount of consideration paid on the cancellation of shares in the relevant class (that is not a dividend under ss CD 22 or CD 24).

For example, s CD 43(24) requires that the ASC of any shares in an amalgamated company held by an amalgamating company that are cancelled on amalgamation are included in the "returns" amount.

References

Subject references
Amalgamated company; Amalgamating company; Amalgamation; Available subscribed capital
Legislative references
Income Tax Act 2007 – ss CD 43(1), (2)(b), (15) and YA 1
Related rulings/statements
"QB 13/02: Income tax – Determining the 'subscriptions' amount for an amalgamated company under the available subscribed capital rules" *Tax Information Bulletin* Vol 25, No 6 (July 2013): 50

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.

EVASION SHORTFALL PENALTIES

Case	TRA 004/12 [2014] NZTRA 03
Decision date	2 May 2014
Act(s)	Tax Administration Act 1994
Keywords	Evasion shortfall penalties, subjective recklessness

Summary

The Taxation Review Authority ("TRA") found that the disputant was subjectively reckless because, with full appreciation of the risks, he made a conscious decision to understate his income and advanced his own interpretation of the tax legislation. The disputant was found liable for evasion shortfall penalties.

Impact of decision

The decision confirms that subjective recklessness can amount to evasion.

Facts

The disputant was a director and shareholder of X Limited. He received a shareholder salary in the 2007 and 2008 income years which he omitted from his tax returns. The Commissioner of Inland Revenue ("the Commissioner") assessed the disputant for evasion shortfall penalties for those two years. The disputant accepts that gross carelessness penalties apply but disputes that he is liable for evasion penalties.

The Commissioner issued default assessments in respect of the 2000 and 2001 income tax years. The disputant filed a notice of proposed adjustment ("NOPA"). However, subsequently following professional accounting advice (from his own accountant and the accountants for X Limited), he filed amended returns which included his shareholder salary as income.

The disputant correctly returned his shareholder salary in his 2002 and 2003 income tax returns.

The disputant was introduced to Mr A and his associates. The disputant said Mr A showed him material which said that where a person exchanges labour for reward there is an equal exchange of value so that no amount of income arises and there is no "profit" which might be taxable ("reward for labour argument"). The disputant was so convinced that he stopped listening to his accountants and appointed a member of Mr A's group as his agent to deal with his tax matters.

The agent prepared the disputant's 2004 and 2005 returns which included the disputant's shareholder salary but deducted an amount described as "reward to [disputant's name]" which was roughly equivalent to the shareholder salary. The disputant filed his 2006 tax return on the same basis.

The Commissioner issued a NOPA in respect of the 2004, 2005 and 2006 returns.

The disputant filed a notice of response which argued that under section 109, his returns were deemed to be correct and could not be challenged by the Commissioner. He also made the reward for labour argument.

The Commissioner issued a statement of position ("SOP") which set out the Commissioner's position on the reward for labour argument and the meaning and effect of section 109. The disputant did not file an SOP. Accordingly, he was deemed to have accepted the Commissioner's position.

The disputant's income tax returns for 2004, 2005 and 2006 were adjusted and shortfall penalties for evasion were imposed.

In March 2008, the disputant filed his 2007 income tax return and did not return his shareholder salary.

In May 2008, the disputant filed amended returns for the 2004, 2005 and 2006 income years, but did not include his shareholder salary in his amended returns.

In August 2008, the disputant filed his 2008 income tax return and did not return his shareholder salary.

In February 2009 the Commissioner advised that discrepancies had been found in the 2007 and 2008 tax returns and penalties would be considered under Part IX of the Tax Administration Act 1994 ("TAA").

In 2010, the disputant pleaded guilty to charges under section 143A(1)(c) of the TAA for knowingly providing false or incomplete information to the Commissioner by filing false or incomplete tax returns in respect of the 2007 and 2008 income years. He was convicted and fined on both charges.

The disputant entered arrangements with the Commissioner to pay the outstanding tax but he disputed the imposing of evasion shortfall penalties.

Decision

Sinclair DCJ confirmed the Commissioner's evasion shortfall penalty assessments for the 2007 and 2008 income tax years.

The Commissioner argued direct intention: that the disputant intended to avoid the assessment and payment of tax which he knew he was obligated to pay. In the alternative, the Commissioner argued subjective recklessness: the disputant appreciated there was a positive risk that in taking his tax position he would breach a tax obligation and proceeded regardless.

Counsel for the disputant, submitted the disputant honestly believed that the arguments he relied upon when he filed his returns were correct. She referred to *Case S100* (1996) 17 NZTC 6,626 at 7,634.

Sinclair DCJ found that at the time the disputant filed his 2007 income tax return, he knew that the Commissioner was of the view that he was required to file a tax return declaring his shareholder salary. He also knew that the accountants for X Limited were of the same view, and he had previously been advised by his own accountants to file amended returns including his shareholder salary as income.

Sinclair DCJ considered the disputant's submission—that the disputant did take note of the advice given by the Commissioner and that it was a question of how the disputant construed that advice—lacked any merit. Sinclair DCJ held that "the disputant simply cherry picked what the Commissioner had to say to continue his own argument" [43].

Sinclair DCJ put weight on the fact that the disputant had chosen at an early stage not to take tax advice from a tax accountant.

Taking into account all the evidence, the TRA was not satisfied to the requisite standard that the disputant had the necessary intention to evade his tax obligations when he filed his 2007 and 2008 returns.

However, Sinclair DCJ found that the disputant was subjectively reckless:

1) Whilst accepting that the disputant had strongly held views and even if the disputant was convinced that his interpretation of the law was correct, Sinclair DCJ was not satisfied, on the facts, that as a consequence of those views that the disputant did not appreciate, or was somehow blind to, the risk that he was taking in understanding his income if he was wrong. [48]
2) Sinclair DCJ was satisfied that it could be inferred from the facts that the disputant knew the risk that if he was wrong he would be liable to pay tax on his shareholder salary. [49]
3) Sinclair DCJ was satisfied to the requisite standard that the disputant, with full appreciation of that risk, made a conscious decision to return the understated income advancing his own interpretation of the tax legislation. [50]

RECONSTRUCTION UNDER THE "DIVIDEND STRIPPING" PROVISION UPHELD

Case	TRA 001/13 [2014] NZTRA 04
Decision date	16 May 2014
Act(s)	Income Tax Act 2004, Tax Administration Act 1994
Keywords	Tax avoidance, reconstruction provisions, dividend stripping, shortfall penalties for taking an abusive tax position

Summary

The Taxation Review Authority ("TRA") upheld the Commissioner of Inland Revenue's ("the Commissioner's") assessment to reconstruct the disputants' income under section GB 1(3) of the Income Tax Act 2004.

Impact of decision

This is the first case in which the Commissioner's reconstruction under the dividend stripping rule in section GB 1(3) has been upheld by the Courts and it reconfirms established principles around the wide powers of reconstruction under section GB 1.

Facts

The disputants ("Mr and Mrs G") were the directors and shareholders of A Limited ("Holdings") and X Limited ("Specialists").

In the 2007 year, Holdings returned a taxable profit of $558,047 and had retained profits of $1,856,277. Mr G returned taxable income of $49,023 in the 2007 year but funded his lifestyle by drawing down funds from his shareholder account in Holdings. By the 2007 year, his shareholder account was overdrawn by $1,079,657.

Specialists owned a separate business venture and in the 2007 year returned a taxable profit of $653,906 but had accumulated losses of $2,237,166.

In December 2006 (after receiving tax advice), the disputants incorporated Q Limited ("Group"). On 1 February 2007, the disputants sold their shares in Holdings to Group for $1.84 million. Group funded the purchase of the shares by obtaining a loan from the disputants on a payable on demand basis.

The disputants treated the amounts they received from the sale of their shares in Holdings to Group as being capital in nature. Mr G's overdrawn shareholder current account liabilities in Holdings were repaid and funds were credited to shareholder accounts in Group. There was a further $521,913 available to be drawn down by the disputants in the future.

Specialists issued 1,949,900 shares in Holdings at a purchase price of $1,949,900 and capitalised an existing loan of $2,024,900. Specialists and Holdings agreed to set off the purchase price of $1,949,900 against the existing loan debt of $2,024,900.

The Commissioner voided the arrangement under section BG 1 of the Income Tax Act 2004 and then assessed the disputants in the 2007 year on the basis that the consideration received for the sale of their shares in Holdings was in substitution for a dividend under the "dividend stripping rule" in section GB 1(3).

The disputants admitted that the sale of their shares in Holdings to Group was a tax avoidance arrangement under section BG 1. The challenge proceedings were filed on the basis that the Commissioner's reconstruction under section GB 1(3) was wrong, because the effect of section BG 1 was to void the transaction in its entirety so that there was no remaining tax advantage to the disputants. The disputants also challenged the imposition of shortfall penalties for taking an abusive tax position.

Decision

Sinclair DCJ began by referring to the following relevant legal principles in relation to the Commissioner's power to counteract a tax advantage obtained under a tax avoidance arrangement:

1) Pursuant to section BG 1, a tax avoidance arrangement is void as against the Commissioner for income tax purposes; TRA 001/13 [2014] NZTRA 04 (the judgment) at [17], but that section BG 1 does not in itself create a liability for income tax; [17]
2) That the Commissioner may counteract a tax advantage obtained by a person under a tax avoidance arrangement under section BG 1(2); and that, under section GB 1(1), the Commissioner may exercise her reconstructive powers in the manner as she thinks appropriate [18]; but that she does not have to base the adjustment on a hypothetical arrangement that the taxpayer may have entered into in the absence of the tax arrangement [21] (see also *Accent Management Limited v Commissioner of Inland Revenue* (2007) 23 NZTC 21,323 (CA);
3) Under section GB 1(3), consideration under a sale of shares is deemed to be a dividend if the sale is part of a tax avoidance arrangement and some or all of the consideration received in the opinion of the Commissioner, represents, is equivalent to, or is in substitution for an amount which the person would, might be expected to, or in all likelihood would have derived as a dividend in that tax year or subsequent years, if the arrangement had not been entered into [23].

Her Honour rejected the disputants' submission that no tax advantage remained to be counteracted (they submitted that the effect of section BG 1 was that the loans owing to Holdings and Specialists remained owing and to be paid for income tax purposes). Sinclair DCJ held that section BG 1(1) voids the tax effect of the arrangement but does not void the underlying transaction as between the parties.

Her Honour noted that the purpose of section BG 1, and related reconstruction provisions, is to remove the tax advantage. In the present case, the sale of the shares had the effect of crediting the disputants' current accounts so that Mr G's indebtedness to Holdings was repaid. It also enabled the disputants to maintain this pattern of drawings into the future as there were still funds available to be drawn down and this resulted in a tax advantage for the disputants.

The TRA held that the consideration received by the disputant on the sale of the shares was in substitution for a dividend which the disputants "would, might be expected to, or in all likelihood would have derived or would derive" as a dividend in the 2007 tax year or subsequent years, if the arrangement had not been made and that the requirements of section GB1(3) were satisfied [56].

Shortfall penalties

Her Honour held that the Commissioner's imposition of shortfall penalties under section 141D of the Tax Administration Act 1994 was correct.

Sinclair DCJ rejected the disputants' argument that Parliament did not intend the expression "shortfall" to apply in a case like this. Her Honour held that Parliament clearly envisaged that the exercise of the Commissioner's powers under section GB 1(3) or under section GB 1(1) of the Income Tax Act 2004 would likely result in a taxpayer facing a "tax shortfall" and a shortfall penalty. In this case the requirements for a shortfall penalty have been met.

Her Honour found that the disputants' tax position was an unacceptable tax position and that the arrangement lacked commercial reality, involved a degree of artificiality in the ownership and control of the entities and found that the arrangement had the dominant purpose of avoiding tax. Sinclair DCJ also made reference to the tax consultant's letter dated 31 August 2006, advising on the restructuring arrangement, rejecting the disputants' contention that the advice immunised them from a statutory liability for shortfall penalties.

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