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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.

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IN SUMMARY

IN SUMMARY

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 16/08: Income tax – deductibility of the costs of obtaining a detailed seismic assessment of a building

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

This Question We've Been Asked is about ss DA 1(1) and DA 2(1).

The risk of earthquakes is an ongoing reality in New Zealand. Since the Canterbury earthquakes and the introduction of the Building (Earthquake-prone Buildings) Amendment Act 2016, taxpayers are trying to determine how their buildings are likely to cope in an earthquake. One means of doing this is to obtain a detailed seismic assessment.

Question

1. Is the cost of obtaining a detailed seismic assessment (DSA) of a building deductible to a business?

Answer

2. With one exception, the costs incurred in obtaining a DSA (DSA costs) in the situations identified at [7], [9] and [10] are deductible. The exception is where a DSA is obtained as part of a capital project. In this case, the DSA costs take their nature from that project and are non-deductible capital expenditure.

Explanation

Introduction

3. A DSA is an engineering assessment that provides a detailed assessment of the seismic performance of a building. The focus of the DSA is on the likely behaviour of the building and its components in an earthquake. A DSA should identify any vulnerabilities in the building and give an earthquake rating (expressed as a percentage of the new building standard). It may also identify possible ways of mitigating the vulnerabilities and estimate the mitigation costs, depending on the owner's instructions.
4. This item covers DSA costs incurred by taxpayers who:
   - are in the business of renting out commercial or residential buildings;
   - own buildings used for their own businesses;
   - get DSAs on someone else's building where the safety of that building may impact on the taxpayer's business.
5. The Commissioner considers that the same considerations and conclusions apply to the costs of other less detailed seismic assessments (including initial seismic assessments) when they are obtained by taxpayers in the same situations as those identified in this item. Less detailed seismic assessments may be obtained as a less costly alternative to DSAs.
6. A DSA can be obtained in a variety of situations and for varying reasons. This item addresses the deductibility of DSA costs in the most commonly occurring situations. It does not address the deductibility of DSA costs incurred when buying a building.
7. A DSA is most commonly obtained when a city or district council has identified a building as potentially earthquake prone (more fully discussed at [8]). An earthquake-prone building is often described as one that has an earthquake rating of less than 34% of the new building standard.
8. The Building (Earthquake-prone Buildings) Amendment Act 2016 requires city and district councils to actively identify and require owners to take action on earthquake-prone buildings. The process for doing this can generally be described as follows:
   - **Identify potentially earthquake-prone buildings** – The council makes a high-level assessment of a building to determine whether the building is potentially earthquake prone.
   - **Obtain further information** – For buildings identified as potentially earthquake prone, the building owner must obtain further information to determine whether the building is earthquake prone. This may involve the owner obtaining a DSA, because it provides a reliable and detailed assessment of the seismic performance of a building.

- **Take action on earthquake-prone buildings** – If a building is confirmed as earthquake prone, the building owner and the council may discuss the available options and develop an agreed approach for the building.

9. A DSA may also need to be obtained when a building consent is required under the Building Act 2004 to alter a building (s 112 of the Building Act 2004). It may also be required when the use of a building changes (s 115 of the Building Act 2004).
10. Taxpayers may also choose to obtain a DSA:
    - as part of a project to seismically strengthen a building;
    - to satisfy existing or potential tenants of a building's safety;
    - to get insurance or to reduce insurance premiums;
    - to identify possible damage after an earthquake;
    - to evaluate the safety of someone else's building where the safety of that building may impact on the taxpayer's business.
11. This item briefly sets out the relevant principles of deductibility under the Income Tax Act 2007, being the general permission and the capital limitation. It then considers whether DSA costs incurred in the situations identified in this item are deductible.

Principles of deductibility

General permission

12. Expenditure must first satisfy the general permission under s DA 1 to be deductible. Therefore, to be deductible, DSA costs must be incurred either in deriving income (s DA 1(1)(a)) or in the course of carrying on a business to derive income (s DA 1(1)(b)).
13. Section DA 1(1)(b) applies only to taxpayers who carry on a business. As set out in [4], this item applies to DSA costs incurred by taxpayers in business. In contrast to s DA 1(1)(a), under s DA 1(1)(b) expenditure need not be directly related to the derivation of income but is deductible when incurred in carrying on a business for the purpose of deriving income. This allows a broader approach:
    - To be expenditure incurred in carrying on a business, the expenditure must be incurred as part of the taxpayer's business operations to obtain assessable income: *FCT v Wells* 71 ATC 4,188 (HCA); *John Fairfax and Sons Pty Ltd v FCT* (1959) 101 CLR 30 (HCA).
    - Whether expenditure has a sufficient relationship to the taxpayer's business operations is usually determined from objective matters. However, subjective matters may be relevant where the expenditure was incurred by choice and the relationship between the expenditure and the business operations is more indirect and remote: *CIR v Banks* [1978] 2 NZLR 472 (CA) at 477; *Magna Alloys & Research Pty Ltd v FCT* 80 ATC 4,542 (FCAFC) at 4,548, 4,558–4,559; *Fletcher v FCT* 91 ATC 4,950 (HCA) at 4,957; *Putnin v FCT* 91 ATC 4,097 (FCAFC); *Schokker v FCT* 99 ATC 4,504 (FCAFC).
    - Longer-term objectives can be considered. A deduction is allowed for expenditure incurred to protect or advance a business or to avoid or reduce costs: *Europa Oil (NZ) Ltd (No 2) v CIR* (1974) 1 NZTC 61,169 (CA) at 61,196–61,197; *Cox v CIR* (1992) 14 NZTC 9,164 at 9,168.
14. The Commissioner's Interpretation Statement "IS 14/04: Income tax — Deductibility of company administration costs", *Tax Information Bulletin* Vol 26, No 7 (August 2014): 5, at [26]–[28] discusses the principles of deductibility under s DA 1 in more detail.

Capital limitation

15. The capital limitation in s DA 2(1) may override the general permission. The capital limitation denies deductions for capital expenditure or losses.

General principles

16. Two general principles form the basis for the distinction between capital and revenue expenditure. Dixon J formulated these principles in *Hallstroms Pty Ltd v FCT* (1946) 72 CLR 634 (HCA) at 647:

    > ... the contrast between the two forms of expenditure corresponds to the distinction between the acquisition of the means of production and the use of them; between establishing or extending a business organization and carrying on the business; between the implements employed in work and the regular performance of the work in which they are employed; between an enterprise itself and the sustained effort of those engaged in it.

QUESTIONS WE'VE BEEN ASKED

And at 648:

> What is an outgoing of capital and what is an outgoing on account of revenue depends on what the expenditure is calculated to effect from a practical or business point of view rather than on the juristic classification of any legal rights secured, employed or exhausted in the process.

17. In *Commissioner of Taxes v Nchanga Consolidated Copper Mines* [1964] AC 948 the Privy Council applied the distinction between capital and revenue drawn in *Hallstroms*. Viscount Radcliffe stated at 960:

> Again courts have stressed the importance of observing a demarcation between the cost of creating, acquiring or enlarging the permanent (which does not mean perpetual) structure of which the income is to be the produce or fruit and the cost of earning that income itself or performing the income earning operations. Probably this is as illuminating a line of distinction as the law by itself is likely to achieve …

BP Australia factors

18. The Privy Council further developed these principles in *BP Australia Ltd v FCT* [1965] 3 All ER 209. The Privy Council set out several "factors" for helping to determine whether expenditure is revenue or capital under the general principles. These factors can be useful where the classification of expenditure as capital or revenue is unclear. The *BP Australia* factors, as applied and developed in later cases, are:
    - the **need or occasion** that calls for the expenditure;
    - whether the expenditure is **recurrent in nature**;
    - whether the expenditure is on the **business structure** or whether it is part of the **income-earning process**;
    - whether the expenditure creates an **identifiable asset**;
    - whether the expenditure is of a once and for all nature producing assets or advantages of an **enduring benefit**;
    - whether the expenditure is sourced from **fixed or circulating capital**; and
    - how the expenditure is treated under **ordinary principles of commercial accounting**.
19. The Commissioner's Interpretation Statement "IS 12/03: Income tax — deductibility of repairs and maintenance expenditure — general principles", *Tax Information Bulletin*, Vol 24, No 7 (August 2012): 68, at [107] discusses the *BP Australia* factors in more detail.
20. In *BP Australia*, the Privy Council stated that it is not appropriate to determine the issue under any rigid test or description. It has to be determined from many aspects of the whole set of circumstances, some of which may point in one direction, some in the other. Many of the above factors will overlap, and some factors will carry more weight than others on particular facts: *BP Australia* at 264.
21. The Privy Council's approach in *BP Australia* has been recognised and applied in New Zealand cases, including:
    - *CIR v McKenzies New Zealand Ltd* (1988) 10 NZTC 5,223 (CA);
    - *CIR v LD Nathan and Co Ltd* [1972] NZLR 209 (CA); and
    - *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271 (CA).

Costs incurred as part of one overall project

22. In addition to the general principles and the BP Australia factors, the courts have suggested that costs incurred as part of one overall capital project will likely take their nature from that project. It is not appropriate to separate out the different costs of the project for tax purposes where that project is capital in nature. This is regardless of whether that project concerns work done on a single asset or a group of assets: *Colonial Motor Co Ltd v CIR* (1994) 16 NZTC 11,361 (in the context of a seismic strengthening project) and followed in *Hawkes Bay Power Distribution Ltd v CIR* (1998) 18 NZTC 13,685 and *Case X26* (2006) 22 NZTC 12,315. Whether a DSA is obtained as part of a capital project is a question of fact in each case. (See Interpretation Statement IS 12/03 at [185]–[208] and examples 17, 19 and 20 for further discussion of the tax treatment of costs incurred as part of one overall project.)

Consideration of the capital or revenue issue in *Trustpower*

23. The Supreme Court recently considered a capital or revenue issue in *Trustpower Ltd v CIR* [2016] NZSC 91. The issue was whether expenditure incurred on obtaining resource consents for four proposed electricity generation projects was on revenue or capital account. The expenditure was described as feasibility expenditure on the basis that it was incurred to assist Trustpower to determine whether to complete the four generation projects.

24. The Supreme Court stated that the general rule is that expenditure referable to a proposed capital project will be capital. The court went on to acknowledge that early-stage feasibility expenditure referable to proposed capital projects may, nevertheless, sometimes be deductible. However, it considered that this would not extend to costs that are intended to (or do) materially advance the capital projects in question.

Deductibility of DSA costs

General permission

25. It is part of a business's normal costs to keep important business structures in good working order. Buildings need to be checked throughout their lives to make sure they are performing and will continue to perform as required. Sometimes buildings need to be checked because of an external risk. The Commissioner considers that a building's possible earthquake-prone status is such a risk. It is an abnormal event resulting in DSA costs being incurred in carrying on a business. The DSA costs can be reasonably regarded as unavoidable and for the purpose of the business generally: *John Fairfax*. Therefore, the Commissioner considers that these DSA costs satisfy the general permission in s DA 1(1)(b). Such DSA costs are costs a prudent business incurs to ensure its ongoing ability to earn income.

26. However, as stated, the capital limitation in s DA 2(1) may override the general permission. Therefore, the rest of this item focuses on whether the capital limitation applies to deny a deduction for the DSA costs incurred in the situations identified at [7], [9] and [10].

Capital limitation

27. Considerable case law exists on the distinction between capital and revenue expenditure. According to Dixon J at 648 in *Hallstroms*, deductibility "depends on what the expenditure is calculated to effect from a practical or business point of view". *BP Australia* sets out factors for helping to determine whether a particular expense is capital or revenue. The fact that expenditure relates to a capital asset does not of itself mean it is capital in nature and, therefore, not deductible. For example, expenditure on repairs and maintenance on a building, rates and building warrants of fitness are all deductible despite relating to what is generally a capital asset for most businesses (that is, the building).

28. While *Trustpower* adds to that case law, the Commissioner considers that *Trustpower* is not relevant to the situations identified and considered in this item. This is because the DSA costs are incurred in relation to an existing capital asset (that is, a building). In *Trustpower*, the expenditure was incurred on projects that, if they came to fruition, would result in the acquisition or development of new capital assets. Those capital assets did not exist when the expenditure on the resource consents was incurred. Therefore, the following paragraphs consider the deductibility of these DSA costs under the general principles formulated in *Hallstroms* and applied and developed in *Nchanga*.

29. The starting point is to determine what the expenditure is calculated to effect from a practical or business point of view. The following paragraphs consider the *BP Australia* factors as a means of assisting in addressing this question.

30. In some situations, such as where a DSA is obtained when a building has been identified as requiring earthquake strengthening, the **need or occasion** for incurring the DSA costs is, arguably, to determine the extent of the strengthening work required on the building. This supports a capital outcome.

31. However, other instances may support a revenue outcome. An example is where a DSA is obtained to satisfy potential tenants of a building's safety. Arguably, in such cases the **need or occasion** for the DSA is to attract tenants or justify the rental charged. Similarly, where a DSA is obtained to get insurance or to reduce insurance premiums – the **need or occasion** is, arguably, to secure insurance or reduce premiums. This also suggests the expenditure was incurred as part of ordinary business operations.

32. Where a DSA is obtained following the council identifying the building as potentially earthquake prone, it might be argued that the expenditure is necessary to satisfy the legal requirement arising from the council identifying the building as potentially earthquake prone, so is revenue in nature. However, the existence of a statutory obligation to incur expenditure does not necessarily mean that expenditure incurred in complying with the obligation is deductible: *FCT v The Swan Brewery Co Ltd* 91 ATC 4,637 (FCAFC)). On the other hand, it is arguable that the **need or occasion** for the DSA costs in this situation is to show whether the building is in fact earthquake prone (and by how much it fails or exceeds the required standard). From a practical or business point of view, the expenditure is incurred to determine whether any further action needs to be taken. This is so regardless of the outcome of the DSA (ie, that the building is or is not earthquake prone). While the expenditure relates to a capital asset, that does not preclude it from being deductible. This factor, which the Commissioner considers important in the context of DSA costs, supports a revenue outcome.

33. DSA costs incurred in any of the situations identified in this item are likely to be one-off expenses rather than **recurrent in nature**. However, simply because an expense is one off does not necessarily mean it is capital in nature. While obtaining a DSA to find out whether a building is earthquake prone may be a one-off occurrence, owners may regularly consider the viability of their buildings (for example, by obtaining an annual building warrant of fitness). Ensuring the ongoing usefulness of its building is likely to be a regular part of a business's undertaking. This would support the DSA costs being a revenue expense.

34. The next *BP Australia* factor is whether DSA costs are part of the **income-earning process** or incurred on the **business structure**. In the Commissioner's view, this is a significant factor in the context of DSA costs. Obtaining a DSA to attract tenants or justify the rental charged may be argued to be like a marketing expense, which is expenditure on the income-earning process. Also, DSA costs incurred to reduce insurance premiums are incurred to reduce an otherwise deductible expense. This is often argued to be part of the income-earning process and therefore deductible. Similarly, it is arguable that finding out whether a building is earthquake prone does not add anything to the business structure. This is also true where a DSA is obtained on someone else's building. Conversely, it might be said that gaining information about the structure of a building (a capital asset) is fundamentally a matter of capital. However, as stated at [27], the fact that expenditure relates to a capital asset does not of itself mean it is capital in nature and therefore not deductible. The result is that in most of the scenarios considered, the DSA costs more closely relate to the **income-earning process** than the business structure.

35. Turning now to whether the DSA costs create an **identifiable asset** or produce assets or advantages of an **enduring benefit**, the first point to note is that the Commissioner considers that the DSA itself is not a capital asset. In the scenarios set out above, a DSA will simply provide the building owner with information. Finding out whether a building is earthquake prone does not create an identifiable asset or produce assets or advantages of an enduring benefit. This is because nothing is being done to the building. It is what the business does with that information that can result in an enduring benefit. However, where a DSA is obtained as part of a capital project (such as a capital project to seismically strengthen a building), it may be part of a project specifically intended to produce an **enduring benefit**.

36. Finally, whether the DSA costs are sourced from **fixed or circulating capital** and how they are treated under **ordinary principles of commercial accounting** are not helpful in this case. These factors are not determinative, and the courts have rarely given them much weight. However, to the extent that it may be relevant, DSA costs are generally expected to be funded from circulating capital and expensed for accounting purposes.

Summary

37. DSA costs are incurred in a variety of situations as set out above. Correctly characterising what the DSA costs are calculated to effect from a practical or business point of view is important across the variety of situations. However, it is a matter on which different views can reasonably be held. The *BP Australia* factors have been considered as a means of assisting with this enquiry. The Commissioner considers that the *BP Australia* factors that should be given the most weight in the context of the deductibility of DSA costs all support a revenue outcome:

- The **need or occasion** for the DSA costs – the need or occasion for the DSA costs, while different from scenario to scenario, suggests that in the situations identified above the DSA costs are incurred as part of ordinary business operations.
- Whether DSA costs are part of the **income-earning process** or on the **business structure** – in the scenarios considered, a significant connection exists between the DSA costs and the income-earning process. Simply finding out whether a building is earthquake prone does not add anything to the business structure.
- Whether the DSA costs create an **identifiable asset** or produce assets or advantages of an **enduring benefit** – the DSA costs do not create an identifiable asset or produce assets or advantages of an enduring benefit. The DSA is not a capital asset, it simply provides the building owner with information about whether the building is earthquake prone. Nothing is being done to the building. It is what the building owner does with that information that can result in an enduring benefit.

38. The exception is where DSA costs are incurred as part of a capital project (such as the seismic strengthening project in *Colonial Motor*). The Commissioner considers that, as set out at [22], these DSA costs would be capitalised into the project and not deducted for tax purposes: *Colonial Motor*, *Hawkes Bay Power* and *Case X26*.

Conclusion

39. The Commissioner considers that, from a practical or business point of view, expenditure on a DSA in the situations identified in this item is incurred to obtain information so as to determine whether a building is earthquake prone (and by how much it fails or exceeds the required standard). Such expenditure should be treated as revenue in nature and deductible. This outcome is consistent with increasing certainty and reducing compliance costs.

40. However, where the DSA costs are incurred as part of a capital project they will be capital in nature and non-deductible.

References

Subject references

capital limitation
detailed seismic assessment
earthquake strengthening
seismic strengthening

Legislative references

Building Act 2004
Building (Earthquake-prone Buildings) Amendment Act 2016
Income Tax Act 2007 – ss DA 1 and DA 2(1)

Case references

BP Australia Ltd v FCT [1965] 3 All ER 209 (PC)
Buckley & Young Ltd v CIR (1978) 3 NZTC 61,271 (CA)
Case X26 (2006) 22 NZTC 12,315
CIR v Banks [1978] 2 NZLR 472 (CA)
CIR v LD Nathan and Co Ltd [1972] NZLR 209 (CA)
CIR v McKenzies New Zealand Ltd (1988) 10 NZTC 5,223 (CA)
Colonial Motor Co Ltd v CIR (1994) 16 NZTC 11,361 (CA)
Commissioner of Taxes v Nchanga Consolidated Copper Mines [1964] AC 948 (PC)
Cox v CIR (1992) 14 NZTC 9,164
Hallstroms Pty Ltd v FCT (1946) 72 CLR 634 (HCA)
Europa Oil (NZ) Ltd (No 2) v CIR (1974) 1 NZTC 61,169 (CA)
FCT v The Swan Brewery Co Ltd 91 ATC 4,637 (FCAFC)
FCT v Wells 71 ATC 4,188 (HCA)
Fletcher v FCT 91 ATC 4,950 (HCA)
Hawkes Bay Power Distribution Ltd v CIR (1998) 18 NZTC 13,685
John Fairfax & Sons Pty Ltd v FCT (1959) 101 CLR 30 (HCA)
Magna Alloys & Research Pty Ltd v FCT 80 ATC 4,542 (FCAFC)
Putnin v FCT 91 ATC 4,097 (FCAFC)
Schokker v FCT 99 ATC 4,504 (FCAFC)
Trustpower Ltd v CIR [2016] NZSC 91

Other references

"IS 14/04: Income tax — deductibility of company administration costs", *Tax Information Bulletin* Vol 26, No 7 (August 2014): 5
"IS 12/03: Income Tax — Deductibility of repairs and maintenance expenditure — general principles", *Tax Information Bulletin* Vol 24, No 7 (August 2012): 68

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.

IS16/06: Income tax - timing - when is income from professional services derived?

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 Interpretation Statement withdraws and replaces:

- "When to Return Directors' Fees" *Public Information Bulletin* Vol 37 (November 1966): 6;
- "Derivation of Income from Services for Income Tax Purposes" *Public Information Bulletin* Vol 159 (February 1987): 1; and
- "Derivation of Income from Services for Income Tax Purposes" *Public Information Bulletin* Vol 172 (March 1988): 1.

These items discussed when fees from professional services are derived and the rules about changing accounting basis. These items were identified during a review of content published before 1996 in the *Public Information Bulletins* and the *Tax Information Bulletins*. 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.

This Interpretation Statement also withdraws and replaces "Whether Doctor Companies can Return Income Using the Cash Basis" *Tax Information Bulletin* Vol 9, No 6 (June 1997): 19. This is explained in more detail from para 77.

This Interpretation Statement consolidates the general principles discussed in the replaced items, and explains how those principles apply beyond the specific examples discussed in those items.

Summary

1. The two main methods used to determine ***when*** an amount of income has been derived are the cash basis and the accrual basis. No general rule of law requires that any particular profession must account for income using one method or the other. However, the correct method is not a matter of choice or practice. Identifying the correct method is a question of fact, having regard to the nature of the business or income-earning activity of any given professional.
2. The courts consider a variety of factors when determining which method is appropriate for a particular business or profession. Not all factors will be relevant in every case and the factors will likely be given different weight. The courts consider these factors:
    - the type of activity carried on by the taxpayer that gave rise to the income;
    - the characteristics of the type of income at issue;
    - the legal and regulatory environment in which the taxpayer operates;
    - the scale of the business or income-earning activity; and
    - the level of sophistication or complexity of the business.
3. In each case, these factors must be weighed against one another to decide which method is appropriate.
4. The courts have held that a cash basis may be appropriate in the following circumstances:
    - an ordinary individual who does not carry on a trade, profession, or business;
    - a business or income earning activity involving a professional person marketing nothing but their own services and receiving nothing but professional fees;
    - a business in which expenditure contributes to income in a subsidiary or minor degree; and
    - a business in which the risk of non-collectable trade debts is unusually high.
5. In most other situations where income is earned from professional services, the accrual basis will be appropriate.

INTERPRETATION STATEMENTS

6. When a person accounts for income on a cash basis, that person's income is derived when it is received. When a person accounts for income on an accrual basis, that person's income is derived when it is earned. The time at which income is earned may be evident from the contract. The cases show that determining when professional fees are earned can be broken down into the following questions:
   - First, has the taxpayer performed the services required under the contract and discharged their obligations?
   - Second, is the taxpayer entitled under the contract to demand payment for the services provided?
7. If there is no contract or the terms of a contract do not determine when income is derived, then standard accounting principles and commercial practice may assist in determining when income from professional fees is derived. In particular, it will be necessary to determine whether:
   - the income-earning process is complete;
   - the amount of income can be reasonably calculated; and
   - what has taken place satisfies the general understanding among practical business people of what constitutes a derivation of income.
8. In some situations, it may be necessary to change from a cash basis to an accrual basis or from an accrual basis to a cash basis. In these situations, s EG 2 provides rules for transitioning from one method to the other. The effect of applying s EG 2 is that all income is accounted for when a person moves from a cash basis to an accrual basis. When a person moves from an accrual basis to a cash basis, s EG 2 also prevents income from being double counted.

Introduction

9. This Interpretation Statement withdraws and replaces three items about when fees from professional services are derived:
   - "When to Return Directors' Fees" *Public Information Bulletin* Vol 37 (November 1966): 6 (PIB 37);
   - "Derivation of Income from Services for Income Tax Purposes" *Public Information Bulletin* Vol 159 (February 1987): 1 (PIB 159); and
   - "Derivation of Income from Services for Income Tax Purposes" *Public Information Bulletin* Vol 172 (March 1988): 1 (PIB 172).
10. PIB 159 and PIB 172 considered the rules for changing between accounting bases in the Income Tax Act 1976. This Interpretation Statement also withdraws and replaces "Whether Doctor Companies can Return Income Using the Cash Basis' *Tax Information Bulletin* Vol 9, No 6 (June 1997): 19 (TIB item on doctor companies).
11. This Interpretation Statement explains when a person derives income from professional services. The term "professional services" is used to describe someone who earns income from providing services to a third party through the exercise of personal skill and knowledge. Examples of professional services identified in the *Public Information Bulletin* items were accountants, architects, chiropractors, consultants, contractors, engineers, solicitors, surveyors, and veterinarians. The items also address barristers sole, medical practitioners and directors in more detail.

Analysis

12. This Interpretation Statement provides guidance on ***when*** income from professional services should be returned for tax purposes. This requires determining when an amount of income has been "derived" for the purposes of the Act. To determine when a person will be treated as deriving income from professional services for tax purposes it is necessary to consider the following questions:
   - When is the cash basis or the accrual basis appropriate?
   - When is income derived under the cash basis?
   - When is income derived under the accrual basis?
13. This Interpretation Statement then applies the general principles to medical practitioners, barristers sole, and directors (updating the *Public Information Bulletin* items on these professions). This Interpretation Statement also applies the general principles to professionals who operate through companies (updating the TIB item on doctor companies).
14. Finally, this Interpretation Statement addresses the consequences of changing between the cash basis and the accrual basis.

When is income from professional services derived?

15. To determine when income from professional services is derived, it is first necessary to consider the legislative requirements.

Derivation of income under the Act

16. Every amount of income must be allocated to an income year: s BD 3(1). The general rule is that an amount of income is allocated to the income year in which the amount is "derived": s BD 3(2). Income that has not previously been derived by a person will be treated as derived when it is credited in their account or dealt with in their interest or on their behalf: s BD 3(4).

17. If a provision in Parts C or E to I of the Act apply, then the income is allocated in accordance with that provision. Depending on the facts of each case, a provision in any of Parts C or E to I may determine when income is derived. This Interpretation Statement provides a general explanation of when income from professional fees is derived. This Interpretation Statement assumes that no provision in Parts C or E to I applies, unless expressly stated. Therefore, it is necessary to determine when an amount of income has been "derived" according to general principles.

18. To determine when an amount of income has been derived, s BD 3(3) states that regard must be had to case law, which:
    - requires some people to recognise income on an accrual basis; and
    - requires some people to recognise income on a cash basis; and
    - more generally, defines the concept of derivation.

19. The concepts of "cash basis" and "accrual basis" are explained at para 24.

20. The word "derived" is not defined in the Act. In summary, the courts consider that "derived" means "flowing, springing, or emanating from, and is synonymous with the English tax expression 'arising or accruing'": per Richardson J in *Hawkes Bay Power Distribution Ltd v CIR* (1999) 19 NZTC 15,226 (CA) at [14]. The word "derived" means more than received; it connotes the source or origin, rather than the fund or place, from which the income was taken: *CIR v NV Phillips' Gloielampenfabriken* [1955] NZLR 868 (SC & CA).

21. There are two closely related aspects of the concept of derivation. The first is the source of the income. The source of the income is, for example, the contract or the circumstances from which the income arises. The second aspect is the time at which the income is derived. It is this second aspect with which this Interpretation Statement is concerned.

Case law on derivation generally

22. The courts are reluctant to formulate a universal test for determining when an amount of income has been derived. Previous cases are helpful signposts, but the time at which income is derived will depend on the facts: *Hawkes Bay*. The aim is to identify the method that provides a substantially correct reflex of income: *Commissioner of Taxes (South Australia) v The Executor, Trustee and Agency Company of South Australia Ltd* [1938] 63 CLR 108 (*Carden's case*). Absolute precision is not required: *CIR v Farmers Trading Co Ltd* (1982) 5 NZTC 61,200 (CA). However, it is necessary to determine which method will produce the more accurate picture of a person's income: *Farmers Trading; Horizon Homes Ltd v CIR* (1994) 16 NZTC 11,064.

23. Derivation of income is governed by the principles followed in business and commerce: *Carden's case*. However, business and commercial concepts and principles are persuasive, but not determinative. While accounting standards are not determinative for income tax purposes, they will normally be the first point of inquiry. Accounting standards tolerate a range of "reasonable" treatments. However, for the purposes of the Act, only one method will be appropriate: the method that provides a substantially correct reflex of income: *Farmers Trading*.

When is the cash basis or the accrual basis appropriate?

24. As expressly noted in s BD 3(3), there are two main methods of determining when an amount of income has been derived: the cash basis and the accrual basis (the term "method" is used to refer to both bases). The cash basis method of accounting for income is sometimes referred to as the receipts basis. Similarly, the accrual basis is sometimes referred to as the earnings basis. For ease of reference and in accordance with s BD 3(3), this Interpretation Statement will use the terms "cash basis" and "accrual basis".

25. To determine when a person has derived income, it is necessary to identify the appropriate method of income recognition for the particular taxpayer. Under the cash basis, income is recognised only when it is received. Under the accrual basis, an amount of income is derived when it is earned, regardless of when it is actually received. When an amount of income is earned will depend on the particular facts and circumstances of each case.

26. There appear to be no cases that state that, as a matter of general principle, a person in any particular profession must account on a cash basis: *Federal Commissioner of Taxation v Dunn* 89 ATC 4141 (FCA). The same is true for the accruals basis. Instead, as noted above, the courts will consider which method provides a substantially correct reflex of income: *Carden's case*. This Interpretation Statement discusses the various factors that indicate whether the cash basis or the accrual basis is appropriate.

27. The courts may consider a variety of factors when determining which method is appropriate for a particular business or profession. Not all factors will be relevant in every case. Also, in each case, the factors considered may be accorded differing weights. The factors the courts have considered can be grouped as follows:

- the type of activity carried on by the taxpayer that gave rise to the income;
- the characteristics of the type of income at issue;
- the legal and regulatory environment in which the taxpayer operates;
- the scale of the business or income-earning activity; and
- the level of sophistication or complexity of the business.

28. In each case, these factors must be weighed against one another to decide which method is appropriate. This Interpretation Statement explains each of these factors in more detail from para 29.

Type of activity carried on by the taxpayer

29. The courts will consider the manner in which the taxpayer carries out their business that gave rise to the income. For example, the taxpayer's regular method of contracting and doing business may indicate whether a cash or accrual basis is appropriate: *CIR v National Bank of New Zealand* (1976) 2 NZTC 61,150 (CA).

30. The accrual basis will be more appropriate for most businesses, including professions: *Carden's case*. It is generally accepted that a trader or trading entity should account for income on an accrual basis: *Whitworth Park Coal Co. Ltd (in liq) v CIR* [1961] AC 31; *Fincon (Construction) Ltd v CIR* [1970] NZLR 462 (CA); *CIR v Farmers Trading; CIR v Morrison* (1928-1933) 17 TC 325; *Carden's case*. However, the courts have noted that there may be exceptions to this principle: *National Bank; Morrison; Carden's case*.

31. The courts have held that a cash basis may be appropriate in the following circumstances:

- an ordinary individual who does not carry on a trade, profession, or business: *Whitworth Park; Case F156* (1984) 6 NZTC 60,343;
- a business or income earning activity involving a professional person marketing nothing but their own services and receiving nothing but professional fees: *Morrison; Carden's case; FCT v Firstenberg* 76 ATC 4141;
- a business in which expenditure contributes to income in a subsidiary or minor degree: *Carden's case*; and
- a business in which the risk of non-collectable trade debts is unusually high: *National Bank* per Cooke J.

Characteristics of the type of income at issue

32. The courts will also consider the characteristics of the type of income at issue, if it is relevant. For example, the courts have indicated that a cash basis may be appropriate when the:

- level of expectation of payment inherent in the type of income is typically low: *Carden's case; Arthur Murray (NSW) Pty Ltd v FCT* (1965) 114 CLR 314 (HCA); *Barratt & Ors v FCT* (1992) 92 ATC 4,275.
- receipts are governed or affected by legislation such that there are restrictions on when fees can be recovered: *Australian Gas Light; Firstenberg*.
- income represents a reward for professional skill and personal work: *Carden's case; Morrison*.

Legal and regulatory environment in which the taxpayer operates

33. For taxpayers in a profession, the legal and regulatory environment in which the taxpayer operates may be relevant. For example, the nature of the taxpayer's business may be shaped by the typical contractual obligations they enter into, or constraints imposed on the taxpayer by their regular method of contracting and doing business. For example, in *Firstenberg*, McInerney J said at 4149:

> Whether the remuneration is to be paid in advance of the performance of the service or from time to time during the performance of the service or only on the completion of the performance of those services is a matter which may be regulated by express or implied agreement between the professional man and the client.

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34. In other situations, laws or regulations may affect when income is derived. In *Australian Gas Light* the taxpayer's business was heavily regulated and the circumstances of the taxpayer were described as being "exceptional". In this case the time of derivation was dictated by the statute governing the taxpayer's business.

Scale of the business or income earning activity

35. The scale of the business is relevant to determining the appropriate accounting method for a professional: *Henderson v FCT* 70 ATC 4016; *Firstenberg; Dunn; Barratt*. At one end of the spectrum is the substantial business operation carried on by a large accounting partnership, such as in *Henderson*. In that case, the accrual basis was the appropriate method for an accounting practice with 19 partners and 295 employees. At the other end of the spectrum, is the solicitor in *Firstenberg* who practised on his own account and employed one secretary. In that case, the cash basis was held to be appropriate.

36. Indicators of the scale of a business include the:

- number of employees and the nature of the work they undertake (that is, whether the employees contribute in only a subsidiary or minor way to the earning of income): *Henderson; Firstenberg; Dunn; Barratt;*
- general size of the business (in *Henderson* the firm was conducted in various centres, was the largest firm in Western Australia, and one of the largest firms in Australia); and
- total amount of fees earned and disbursements made: *Henderson*.

37. Where the number of employees is very low or nil, the business is small in size and the total amount of fees earned and disbursements made is low, those factors would indicate that a cash basis might be more appropriate. Otherwise, the accrual basis will be appropriate.

38. In considering the scale of a business, it is necessary to look at the whole of the arrangements. For example, in *Barratt*, the taxpayers were members of a partnership that undertook a pathology practice. Services such as the collection and testing of pathological samples and various nursing, secretarial and courier services were provided to the partnership through a service company that also purchased equipment and was the employer of staff. The shareholders and directors of the service company were the spouses of the partners. The court held that the accruals basis was appropriate. The court based its decision on the following:

- while the partners rendered professional services directly, most of the work from which income was derived was done by nurses and qualified technicians;
- large and expensive plant was used; and
- a large number of staff were employed involving significant expenditure.

Level of sophistication or complexity of the business or income-earning activity

39. The level of sophistication or complexity of the taxpayer's business or accounts may indicate which method is appropriate. In terms of the complexity of the business, an accrual basis may be more appropriate for a business that involves fixed or circulating capital: *Carden's case; Firstenberg*. Another example might be the level of a taxpayer's trade debts: *Whitworth Park; Case F156*. The need to account for trade debts often indicates that an accrual basis will be appropriate. However, a cash basis may be appropriate for a business in which the risk of non-collectable trade debts is unusually high (as suggested in an obiter comment by Cooke J in *National Bank*) or where there is little certainty about the payment of fees (as suggested by Dixon J in *Carden's case* in relation to a medical practice).

40. The level of sophistication or complexity of the taxpayer's accounts may also indicate which accounting method is appropriate: *Dunn*. However, as previously noted, the taxpayer's accounting treatment is not determinative. Nevertheless, the Australian courts have suggested that an accrual basis may be appropriate for a professional when:

- the taxpayer accounts for work in progress and carries the value of that work into a balance sheet at the end of the year: *Dunn*;
- it is necessary to distinguish between income on capital account or income on revenue account: *Firstenberg*; and
- it is necessary to ascertain the "capital account" or the "loan account" of the taxpayer: *Firstenberg*.

Summary

41. In summary, the cash basis will be appropriate for very small-scale professions. Some other indications that a cash basis may be appropriate include:

- the income received represents a reward for professional skill and personal work;
- expenditure contributes to income in a minor way;

- the level of expectation of payment inherent in the type of income is typically low;
- there are no employees;
- if there are employees, they are few and they contribute in only a subsidiary or minor way to the earning of income (an example might be an administrative assistant); and
- sophisticated or complex financial accounts are not required.

42. It is necessary to weigh up all the factors in any particular case to determine whether the cash basis is appropriate. The ultimate question is whether the cash basis provides a substantially correct reflex of income.

43. The accrual basis will be appropriate in all other circumstances.

When is income derived under the cash basis?

44. If a person accounts for income on a cash basis, that person's income is derived when it is received. As stated by Dixon J in *Carden's case* at 155, "the object is to discover what gains have during the period of account come home to the taxpayer in a realized or immediately realizable form".

45. Income that has not previously been derived by a person will be treated as derived when it is credited in their account, or in some other way, dealt with in their interest or on their behalf: s BD 3(4).

Expenditure

46. This Interpretation Statement is concerned with when income is recognised for tax purposes. However, it is important to note that determining when expenditure is recognised for tax purposes is governed by subpart DA. Section DA 1 does not distinguish between the cash basis and the accrual basis for recognition of expenditure. The test is whether the expenditure has been incurred. The courts have defined the term "incurred" to mean "definitively committed to": *FCT v James Flood* (1953) 88 CLR 492; *CIR v Mitsubishi Motors New Zealand Ltd* (1995) 17 NZTC 12,351 (PC). As a result, a person accounting on a cash basis may recognise expenditure before it is actually paid.

When is income derived under the accrual basis?

47. Richardson J (who delivered the judgment for the Court of Appeal) explained the accrual basis in *Farmers Trading*. Richardson J said that the essence of the accrual concept is that both revenue and costs are:
    - accrued (that is, recognised as they are earned or incurred, not as money is received or paid);
    - matched with one another so far as their relationship can be established or justifiably assumed; and
    - dealt with in the profit and loss account of the period to which they relate.

48. Under the accrual basis income is returned at the point at which revenue is "earned", independently of the date payment is made or becomes due: *Hawke's Bay*.

49. There appear to be no New Zealand cases that consider when a professional earns income. However, this issue has been considered in Australia. In addition, the courts in both Australia and New Zealand have considered when income is "earned" more generally.

50. The courts have used various terms to attempt to define the time when income is earned. In Australia, when determining when income from professional services has been derived, the courts have tended to identify the point at which a "recoverable debt" arises (*Henderson, Firstenberg, Barratt*). In New Zealand, the courts have referred to a time when there is an "entitlement to bill" (*Hawkes Bay, PIB 159*). Ultimately, however, regardless of the terminology that is used, the cases show that a taxpayer's earning process is complete when the activity that gives rise to a debt is complete, and no further steps are required to be taken by the taxpayer before being entitled to payment: *Australian Gas Light; Hawke's Bay; Egmont Cooperative Dairies Ltd (In Liq) v CIR* (1996) 17 NZTC 12,536. That is, no contingencies or conditions precedent affect the taxpayer's right to demand payment: *Australian Gas Light; Egmont*.

51. Therefore, the cases show that determining when professional fees are earned can be broken down into the following questions:
    - First, has the taxpayer performed the services required under the contract and discharged their obligations?
    - Second, is the taxpayer entitled under the contract to demand payment for the services provided?

52. If there is no contract or the terms of a contract do not determine when income is derived, then standard accounting principles and commercial practice may assist in determining when income from professional fees is derived. In particular, it will be necessary to determine whether:
    - the income earning process is complete;
    - the amount of income can be reasonably calculated; and
    - what has taken place satisfies the general understanding among practical business people of when income is derived.
53. These tests are discussed in more detail below.

Terms of the contract

54. Generally, the terms of the contract between the professional and the client (where an express contract exists) will determine when an amount of income is derived: *HW Coyle Ltd v CIR* (1980) 4 NZTC 61,558; *Horizon Homes Ltd v CIR* (1994) 16 NZTC 11,064.
55. In *Hawkes Bay*, the Court of Appeal held (at 15,232) that the terms of the contract were a "complete answer" to the question of when the taxpayer derived income. Under the contract in that case, the consumers used electricity and contractually accepted responsibility to pay for it. The consumers' liability to pay arose when they consumed electricity. For its part, the company supplied and sold that electricity and was contractually entitled to read the meter at any time or estimate the usage and render a bill on balance date. While this was not a case about professional services income, the principles can also be applied to professional services situations.
56. Where a contract expressly provides for payment, a taxpayer can be regarded as having only derived income to which they are contractually entitled: *Horizon, Hawkes Bay*. This means that where the contract provides for progress payments, those amounts will be derived only when they are due under the contract. If no payments are due under the contract until completion, the taxpayer cannot derive income to which they are not yet contractually entitled: *Horizon*.
57. The point at which a professional is entitled to demand payment for their services may be apparent in the terms of an express agreement. If there is no express agreement, the right to demand payment may arise periodically (progress billings) or when the work is completed, depending on the facts. Where the contract expressly provides for the time at which the person is entitled to payment of the amount, that time will generally indicate when the income will be derived. Where there is no express agreement, standard accounting principles and business and commercial practice will be relevant to determining the time of derivation of an amount of income.
58. The legal and regulatory environment may also affect the time that income is derived under the contract: *Australian Gas Light Co; Firstenberg*. For example, in *Australian Gas Light*, the taxpayer's business was heavily regulated. The taxpayer was prohibited from demanding payment before the end of the billing periods imposed by statute. The taxpayer only accounted for amounts relating to gas consumed up to 30 June where the relevant meter had been read and an account based on that reading had been issued. The Federal Commissioner of Taxation argued that amounts relating to the gas consumed up to 30 June, but not yet billed, were amounts of assessable income (that is, an accrual basis). The court held that until the taxpayer was entitled under statute to read meters and render bills for gas consumed, the amounts had not been derived.

Standard accounting principles and commercial practice

59. Although expressed in various ways, the courts in New Zealand and Australia have consistently looked to generally accepted accounting principles and commercial practice in determining when income is derived. However, such concepts and principles are only persuasive and are not determinative: *Horizon; Dunn; Barratt; BHP Billiton Petroleum (Bass Strait) Pty Ltd v FCT* (2002) ATC 5169.
60. In *Farmers Trading* Richardson J noted that generally accepted accounting principles are not a "canonical set of rules". Instead, they tolerate a variety of reasonable treatments. While accounting standards will be relevant (and often highly persuasive) only one correct time of derivation will be correct for tax purposes.
61. It is important to note that the cases take account of the standard accounting principles that applied at the time of each decision. Standard accounting principles may change and may be different depending on the standards applied by a particular taxpayer (for example, some taxpayers are subject to the International Financial Reporting Standards).

Summary

62. Income from professional services is derived when it is earned. Income from professional services is earned according to the terms of the contract. The cases show that the earning process is complete when the activity that gives rise to a debt is complete and no further steps are required to be taken before being entitled to payment. Essentially, income is earned (and therefore "derived") when the taxpayer:
    - has performed the services required under the contract and discharged their obligations; and
    - is entitled under the contract to demand payment for the services provided.
63. If there is no contract, or the terms of a contract do not determine when income is derived, then standard accounting principles and commercial practice may assist in determining when income from professional fees is derived. In particular, it will be necessary to determine whether:
    - the income-earning process is complete;
    - the amount of income can be reasonably calculated; and
    - what has taken place satisfies the general understanding among practical business people of when income is derived.
64. Many professionals keep a record of their time as unbilled work in progress ("WIP"). The total of unbilled WIP will not usually represent income of a taxpayer. Instead, the principles stated above will need to be applied to determine the extent to which unbilled WIP can be regarded as income derived.

Prepayments

65. In some circumstances, professionals may be paid amounts prior to having performed any services, for example, by way of an advance, or to be held on trust until the services are performed. Where a professional receives payment in advance of services being provided, the income will not be derived until the professional discharges the obligations for which they have received payment (*Arthur Murray (NSW) Pty Ltd v Federal Commissioner of Taxation* (1965) 114 CLR 314 (HCoA)). The obligations that must be discharged will depend on the terms of the relevant contract. This principle applies to taxpayers who account on either a cash basis or an accruals basis.

How do the general principles apply to medical practitioners, barristers sole, and directors?

66. PIB 159 set out general principles of derivation for professionals. The implication from PIB 159 was that professionals, other than medical practitioners and barristers sole, must account for income on an accrual basis. In addition, PIB 37 stated that directors generally account for income on a cash basis. PIB 37 went on to say that a director may account for income on an accrual basis if it had been their practice to do so.
67. However, as discussed, no general rule of law requires any particular profession to account for income using one method or the other. In addition, the correct method is not a matter of choice or practice. Instead, it is a question of fact having regard to the nature of the business or income earning activity of any given professional and the factors outlined in [27].

Medical practitioners

68. Having regard to the factors outlined in this Interpretation Statement, a medical practitioner's practice may vary in scale. Such practices range from single doctors practising on their own, to groups of doctors practising together and sharing administration costs, to large corporate groups with many employees. In addition, the level of sophistication and complexity among medical practitioners' practices varies widely. Finally, medical practitioners typically contract for their services and there appear to be no legal restrictions on the recovery of fees.
69. Because medical practices vary widely in scale, complexity and sophistication, no particular method will apply to all medical practitioners. Therefore, the Commissioner considers that the principles as outlined above should be applied to each medical practitioner's circumstances to determine the correct reflex of their income.
70. Having regard to the general nature of a medical practice, a medical practitioner who practices as a sole practitioner on a small scale, with no employees (other than, for example, an administrative assistant or secretary who does not bring in fee income) can account on the cash basis. This may also be the case where, while the medical practitioner practises with a group of other medical practitioners in shared premises, they still account for their income on an individual, or sole practitioner, basis. Other medical practitioners who operate through a larger structure should, in most cases, account for income on an accrual basis. This is because the accrual basis is generally appropriate for most businesses, including professions.

Barristers sole

71. A barrister sole's practice is usually small in scale. That is, they are sole practitioners, who often operate in chambers with other barristers sole to share administration costs. A barrister may also operate through an incorporated law firm. However, the Lawyers Conduct and Client Care Rules state that the barrister must be the sole director and voting shareholder. Therefore, a barrister's practice will generally be small in scale.

72. The income a barrister sole earns is predominantly (if not exclusively) fees from personal services or legal aid payments. In addition, the legal and regulatory environment surrounding a barrister's practice places significant limits on recovery of fees. Given that payment is sometimes uncertain, these limits mean it is not always prudent to account for fees before they are received.

73. Having regard to the general nature of a barrister sole's practice, and to provide a true reflex of their income, it is expected that the cash basis would generally be appropriate. This is because most barristers sole are analogous to the sole-practice taxpayers in *Carden's case* and *Firstenberg*.

74. Some barristers may operate a more sophisticated practice on a larger scale than other barristers. Therefore, it is conceivable that the accrual basis may, in some situations, provide a correct reflex of a barrister's income. However, barristers cannot operate through partnerships or companies (unless they are the sole director and voting shareholder), so there are limits on how large in scale a practice can be. A barrister who operates through an incorporated law firm, should also generally account for income on a cash basis. This is because they are still required to operate within the same professional restrictions (ie, they must still operate on their own), whether they are incorporated or not.

Directors

75. The scale of a director's operations may vary. The general principles as outlined in this Interpretation Statement should be applied to the particular circumstances of each director. A director generally provides their services personally. The fees directors earn are received in return for providing specialist knowledge and skill. Most directors would hold one or a small number of directorships. This indicates that the cash basis will generally be the appropriate method.

76. However, some directors may be involved in larger scale operations. Alternatively, some directors might operate through a company as a consultant. These directors might be appointed to multiple boards by virtue of their special expertise. In these situations, the accrual basis likely provides the correct reflex of income.

How do the general principles apply to professionals who operate through companies?

77. Many professionals operate through companies. The *TIB* item on doctor companies stated at 19 that all "doctor companies" must return income on an accrual basis. This is because "the predominant requirement before the cash basis can be used is for the taxpayer's income to be earned as a result of his or her personal exertions".

78. The Commissioner considers that there is no general rule of law that prohibits a company run by a professional in sole practice from accounting for its income on a cash basis. This is provided the professional is the only person providing the services and the scale and sophistication of the business otherwise indicated that the cash basis is appropriate. The derivation of income from personal exertion is one indication that a cash basis is appropriate. Although a company does not provide services personally, the cash basis may still be appropriate for one person providing services through a company where the small scale of the operation would otherwise indicate that the cash basis is appropriate. As discussed in this Interpretation Statement, other factors may, on balance, indicate a cash basis is appropriate.

79. The cash basis is still potentially appropriate for barristers in an incorporated law firm. This is because restrictions are imposed on barristers sole, whether they are incorporated or not. This could reasonably be extended to other professionals who operate their sole practice through a company on a small scale and with a low level of complexity. For example, a sole director who operates through a company is able to account on a cash basis, provided there are no circumstances that indicate that an accrual basis would provide a more correct reflex of income. This is a modification of the view taken in the *TIB* item on doctor companies, which stated that a doctor company must always account on an accrual basis.

What are the consequences of a change in method?

80. In some situations, it may be necessary to change from a cash basis to an accrual basis or from an accrual basis to a cash basis. In these situations, s EG 2 provides rules for transitioning from one method to the other. The effect of applying s EG 2 is that all income is accounted for when a person moves from a cash basis to an accrual basis. When a person moves from an accrual basis to a cash basis, s EG 2 also prevents income from being double counted.

81. When a person moves from a cash basis to an accrual basis, s EG 2(2) requires that amounts owed to the person on the last day of the income year before the year of change is returned as income in the year of change. In addition, an amount owed by the person on the last day of the income year before the year of change is allowed as a deduction in the year of change.

82. When a person moves from an accrual basis to a cash basis, s EG 2(3) provides that the total of all amounts owing by the person in the year of change (that have been allowed as a deduction in earlier income years) is income of the person in the year of change. In addition, the total of all amounts owing to the person in the year of change (that have been treated as income of the person in earlier income years) is allowed as a deduction in the year of change.

83. The amount arising from these adjustment calculations in ss EG 2(2) and (3) is either income under s CH 4 or a deduction under s DB 52.

Meaning of the phrases "amounts owed" and "amounts owing"

84. PIB 172 states that the phrase "amounts owing to", used in a predecessor section to s EG 2, contemplates that a debt has already been established, rather than the "entitlement to bill" concept which is the basis of PIB 159.

85. The precise meaning of the term "owe" (and its derivatives, "owed", "owes", and "owing") will often depend on the context in which the term is used. The words "owed" or "owing" can mean "yet to be paid" or they can mean "due". It is possible for an amount to be owing but not yet due (for example, when the time for payment of a debt has not yet passed): *Bank of New Zealand v Baker* [1926] NZLR 462; *Perrott v Newtown King Ltd* [1933] NZLR 1131.

86. For the purposes of s EG 2, the Commissioner considers that an amount that is "owed" or "owing" is an amount that a person is obligated to pay immediately or in the future to a person who has a right to have it paid to them. An amount "owed" or "owing" to a taxpayer can include amounts for which a person is entitled to demand payment (but for which payment has not yet been demanded, for example, with an invoice). This is consistent with the purpose of s EG 2 to ensure that all income is accounted for, and there is no double counting of income when a person moves from one method to the other. This can also be said to be consistent with the time income is "earned" as discussed above. This position is changed from that stated in PIB 172.

References

Related rulings/statements

'Derivation of Income from Services for Income Tax Purposes' *Public Information Bulletin* Vol 159 (February 1987):1;

'Derivation of Income from Services for Income Tax Purposes' *Public Information Bulletin* Vol 172 (March 1988): 1

'When to return directors' fees' *Public Information Bulletin* Vol 37 (November 1966): 6;

'Whether doctor companies can return income using the cash basis' *TIB* Vol 9, No 6, June 1997: 19

Legislative references

Income Tax Act 2007, ss BD 3, EG 2

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Barristers sole
Derivation
Directors
Income
Income Tax
Medical practitioners
Professional fees

Case references

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Perrott v Newtown King Ltd [1933] NZLR 1131
Whitworth Park Coal Co Ltd (In liq) v C of IR [1961] AC 31

Appendix – Legislation

Income Tax Act 2007

1. Section BD 3 provides:

BD 3 Allocation of income to particular income years

Application

(1) Every amount of income must be allocated to an income year under this section.

General rule

(2) An amount of income is allocated to the income year in which the amount is derived, unless a provision in any of Parts C or E to I provides for allocation on another basis.

Interpretation of derive

(3) When the time of derivation of an amount of income is being determined, regard must be had to case law, which—

(a) requires some people to recognise income on an accrual basis; and

(b) requires other people to recognise income on a cash basis; and

(c) more generally, defines the concept of derivation.

Income credited in account

(4) Despite subsection (3), income that has not previously been derived by a person is treated as being derived when it is credited in their account or, in some other way, dealt with in their interest or on their behalf.

Role of Part E

(5) Part E (Timing and quantifying rules) contains a number of provisions that—

(a) specifically modify the allocation of income or have the effect of modifying the allocation of income; or

(b) allocate income as part of the process of quantifying it.

Single allocation

(6) An amount of income may be allocated only once.

2. Section EG 2 provides:

EG 2 Adjustment for changes to accounting practice

When this section applies

(1) This section applies in an income year (the year of change) when a person changes from—

(a) a cash accounting method to an accrual accounting method of calculating their income tax liability; or

(b) an accrual accounting method to a cash accounting method of calculating their income tax liability.

From cash to accrual accounting method

(2) If subsection (1)(a) applies,—

(a) an amount owed to the person on the last day of the income year before the year of change is income of the person in the year of change; and

(b) an amount owed by the person on the last day of the income year before the year of change is allowed as a deduction in the year of change.

From accrual to cash accounting method

(3) If subsection (1)(b) applies,—

(a) an amount equal to the total of all amounts owing by the person in the year of change that have been allowed as a deduction in earlier income years is income of the person in the year of change; and

(b) an amount equal to the total of all amounts owing to the person in the year of change that have been treated as income of the person in earlier income years is allowed as a deduction in the year of change.

Some definitions

(4) In this section,—

accrual accounting method means a method of accounting that is regarded as accrual accounting under generally accepted accounting practice

cash accounting method means a method of accounting by which the income tax liability of a person is calculated by reference to cash receipts or outgoings.

LEGISLATION AND DETERMINATIONS

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

Special Determination S49: Application of the financial arrangements rules to a public-private partnership

This determination may be cited as *Special Determination S49: Application of the Financial Arrangements Rules to a Public-Private Partnership*.

1. Explanation (which does not form part of the determination)

1.1 This determination relates to an arrangement (the Project) involving the finance, design, construction and provision of ongoing asset management and maintenance services in respect of the Facility by a limited partnership (the Partnership) under a public–private partnership agreement (the Project Agreement) with the Crown.

1.2 Another limited partnership (Holdings) will hold a 100% interest in the Partnership. Holdings has four limited partners. Limited Partner A is exempt from income tax. Limited Partner B is a limited partnership with multiple limited partners, some of whom are exempt from income tax. Limited Partner C and Limited Partner D are both limited liability companies. Limited Partner C, Limited Partner D, and each limited partner of Limited Partner B that is not exempt from income tax are together referred to as the Taxable Limited Partners. This determination only applies to the Taxable Limited Partners and does not apply to those limited partners that are exempt from income tax.

1.3 The Project Agreement comprises three basic components:

- a design and construction phase (the D&C Phase) under which the Partnership agrees to design and construct the Facility for the Crown in consideration for a fixed lump-sum payment (the D&C Payment), payable on completion of the D&C Phase;
- a Facility Lease to be entered into by the Partnership and the Crown under which the Partnership prepays an amount representing the rental the Partnership will pay to the Crown (the Rental Prepayment); and
- an asset management and maintenance phase (the AM&M Phase) under which the Partnership will provide asset management and maintenance services to the Crown over a 25-year term in consideration for monthly payments (the Unitary Payment).

1.4 The Partnership will enter into:

- a Construction Agreement with a contractor (the Contractor), under which the Contractor will design and construct the Facility in consideration for payments; and
- an Asset Management and Maintenance Contract with a service provider (the Service Provider), under which the Service Provider will provide the asset management and maintenance (and other) services in consideration for payments.

1.5 The Partnership will raise debt (the Senior Debt) from Limited Partner A and various third-party financiers. The Partnership will enter into interest rate swaps in respect of the Senior Debt (the Swaps).

1.6 Holdings will also receive funding during the D&C Phase from:

- Limited Partner A and Limited Partner B in the form of convertible debt instruments (the Convertible Notes); and
- Limited Partner C and Limited Partner D in the form of deferred equity contributions backed by letters of credit (the Letters of Credit).

1.7 The Facility Lease, AM&M Phase, Construction Agreement, and Asset Management and Maintenance Contract are all excepted financial arrangements as defined in s EW 5. The D&C Phase, Senior Debt, Swaps, and Letters of Credit are financial arrangements as defined in s EW 3.

1.8 The Project is the subject of two private rulings (BR Prv 16/64 and BR Prv 16/65, issued on 31 October 2016) and is described more fully in those rulings. The D&C Phase is the subject of *Special Determination S50: Application of the Financial Arrangements Rules to the D&C Phase of a Public–Private Partnership*, and the Convertible Notes are the subject of *Special Determination S51: Subordinated Convertible Note in Respect of a Limited Partnership Interest in a Public–Private Partnership*.

1.9 This determination prescribes:

- the amount of consideration that is solely attributable to the Facility Lease;
- how the financial arrangements rules apply to the AM&M Phase, Construction Agreement, and Asset Management and Maintenance Contract; and
- the method for spreading the payments made in respect of the Senior Debt, Swaps, and Letters of Credit.

2. Reference

This determination is made under ss 90AC(1)(bb), 90AC(1)(d) and 90AC(1)(h) of the Tax Administration Act 1994.

3. Scope of determination

3.1 This determination applies to the Partnership in respect of the Project, including the following arrangements:

(a) The D&C Phase of the Project Agreement, under which the Partnership agrees to design and construct the Facility for the Crown and will receive a fixed lump-sum payment (the D&C Payment) once the Facility is ready for operation. The D&C Phase is the subject of *Special Determination S50: Application of the Financial Arrangements Rules to the D&C Phase of a Public–Private Partnership*, so is not covered by this determination.

(b) The AM&M Phase of the Project Agreement, under which the Partnership will provide ongoing asset management and maintenance services for 25 years to the Crown in consideration for monthly payments.

(c) The Facility Lease, under which the Partnership will lease the Facility from the Crown for 25 years and prepay the rental to the Crown (the Rental Prepayment). This payment will be equal to and will offset the payment receivable in relation to the D&C Phase.

(d) A Construction Agreement with the Contractor, under which the Contractor will design and construct the Facility in consideration for payments. The Construction Agreement will:

(i) provide for periodic invoices to be rendered by the subcontractor; and

(ii) require that payment be made within 93 days of an invoice being rendered.

(e) An Asset Management and Maintenance Contract with the Service Provider, under which the Service Provider will provide the ongoing asset management and maintenance (and other) services in consideration for payments. The Asset Management and Maintenance Contract will:

(i) provide for periodic invoices to be rendered by the subcontractor; and

(ii) require that payment be made within 93 days of an invoice being rendered.

(f) Senior Debt, under which the Partnership will borrow an agreed sum from external lenders and Limited Partner A for a term of approximately seven years from financial close of the Project (Financial Close). The Senior Debt will be:

(i) a capitalising, interest-only senior debt facility that converts to an amortising senior tranche on the Conversion Date and a Debt Service Reserve Facility; and

(ii) refinanced within approximately seven years of Financial Close and every five years thereafter over the term of the Project.

In this determination, references to the Senior Debt include any refinancing of that debt on materially the same terms.

Under IFRS (as the standards apply at the date of this determination), the Senior Debt initially will be recognised at fair value plus integral fees, and will be subsequently measured at amortised cost using the effective interest method (regardless of whether or not hedge accounting is applied), and will not be treated as a hedge of another financial arrangement.

(g) Swaps, under which the Partnership will manage the floating interest rate risk on the Senior Debt tranche during the first seven years of the Project.

(h) Convertible Notes, under which Limited Partner A and Limited Partner B provide funding during the D&C Phase. The Convertible Notes are the subject of *Special Determination S51: Subordinated Convertible Note in Respect of a Limited Partnership Interest in a Public–Private Partnership*, so are not covered by this determination.

(i) Letters of Credit, under which Limited Partner C and Limited Partner D provide and maintain investment support.

3.2 Limited Partner B, Limited Partner C and Limited Partner D use IFRSs to prepare financial statements and to report for financial arrangements. Any Taxable Limited Partner that does not use IFRSs to prepare financial statements and to report for financial arrangements will use the same spreading method as Limited Partner B.

3.3 The Taxable Limited Partners will recognise income derived from the Crown and will deduct expenditure incurred, under the relevant provisions of the Act to the extent that the financial arrangement rules do not apply to those amounts.

3.4 This determination is made subject to the following conditions:

(a) This determination shall only apply to a Taxable Limited Partner if such Taxable Limited Partner recognises income and expenditure in respect of the Convertible Note in the manner prescribed by *Special Determination S51: Subordinated Convertible Note in Respect of a Limited Partnership Interest in a Public–Private Partnership*.

(b) This determination shall only apply to a Taxable Limited Partner if such Taxable Limited Partner recognises income in respect of the D&C Payment in the manner prescribed by *Special Determination S50: Application of the Financial Arrangements Rules to the D&C Phase of a Public–Private Partnership*.

(c) Private rulings BR Prv 16/64 and BR Prv 16/65 issued on 31 October 2016 continue to apply (under s 91EB of the Tax Administration Act 1994).

4. Principle

4.1 The Facility Lease is an excepted financial arrangement under s EW 5(9).

4.2 The AM&M Phase, Construction Agreement, and Asset Management and Maintenance Contract are "short-term agreements for sale and purchase" (as defined in s YA 1). Therefore, they are excepted financial arrangements under s EW 5(22).

4.3 The Senior Debt, Swaps and Letters of Credit are "financial arrangements" under s EW 3.

4.4 Together, all of these financial arrangements and excepted financial arrangements (as well as the D&C Phase and Convertible Notes) are a wider "financial arrangement" under s EW 3.

4.5 Any amount that is solely attributable to an excepted financial arrangement described in s EW 5(2) to (16) is not an amount that is taken into account under the financial arrangements rules (s EW 6(2)). Any amount that is solely attributable to an excepted financial arrangement described in s EW 5(17) to (25) is an amount that is taken into account under the financial arrangements rules (s EW 6(3)).

4.6 This determination specifies:

(a) the amounts that are solely attributable to the Facility Lease and not taken into account under the financial arrangements rules;

(b) whether any amounts payable in respect of the AM&M Phase, Construction Agreement, and Asset Management and Maintenance Contract are required to be spread under the financial arrangements rules; and

(c) how payments made under the Senior Debt, Swaps and Letters of Credit must be spread under the financial arrangements rules.

5. Interpretation

In this determination, unless the context otherwise requires:

- All legislative references in this determination are to the Income Tax Act 2007, unless otherwise stated.
- **IFRS** means a New Zealand Equivalent International Financial Reporting Standard in effect under the Financial Reporting Act 2013, and as amended from time to time or an equivalent standard issued in its place.

6. Method

6.1 The amounts that are solely attributable to the Facility Lease and not taken into account under the financial arrangements rules are the:

- Rental Prepayment; and
- property interest granted to the Partnership.

6.2 The Taxable Limited Partners do not have any amounts to spread under the financial arrangements rules in respect of the:

- AM&M Phase;
- Construction Agreement; and
- Asset Management and Maintenance Contract.

6.3 The IFRS financial reporting method in s EW 15D may be used by the Taxable Limited Partners to allocate income and expenditure (other than "non-integral fees" as defined in s YA 1) over the term of the Senior Debt (including any refinancing). None of the restrictions for the application of this reporting method in s EW 15D(2B) apply.

6.4 None of the mandatory spreading methods in s EW 15H or s EWI 15I apply to the Swaps. Over the term of the Swaps, income or expenditure may be allocated using either:

- the expected value method in s EW 15F (other than "non-contingent fees" as defined in s YA 1) provided that the Swaps are not treated as a hedge of other financial arrangements for which the "fair value method" is used and provided that the relevant Taxable Limited Partner has notified the Commissioner of its decision to use this method; or
- the IFRS financial reporting method in s EW 15D (other than "non-integral fees" as defined in s YA 1) provided that the Swaps are not treated as a hedge of other financial arrangements for which a method other than the IFRS financial reporting method is used,

provided that this paragraph 6.4 shall only apply to a Taxable Limited Partner is such Taxable Limited Partner uses the same method for the entire term of the relevant swap and that the method is consistent with s EW 24.

6.5 This determination does not affect the Taxable Limited Partners' obligation to perform base price adjustments under s EW 31 in respect of the Swaps and the Senior Debt at the time of any refinancing.

6.6 The IFRS financial reporting method in s EW 15D may be used to allocated income and expenditure (other than "non-integral fees" as defined in s YA 1) over the term of the Letters of Credit, provided the Letters of Credit are not treated as a hedge of another financial arrangement. None of the restrictions for the application of this reporting method in s EW 15D(2B) apply.

7. Example

This example illustrates the application of the method set out in this determination.

This example is based on the following parameters:

Commencement of D&C Phase	1 December 2016
Completion of D&C Phase	1 December 2021
Completion of AM&M Phase	1 December 2046
D&C Payment from the Crown	$1,000
Aggregate payments to the Contractor	($850)
Facility Lease prepayment	($1,000)
Monthly payments from the Crown during the AM&M Phase	$30
Monthly payments to the Service Provider	($15)
Annual interest on the Senior Debt	($85)
Annual interest on the Convertible Note	($15)
Annual net payments in respect of the Swaps	($7)
Annual Investment Commitment Fee for the Letters of Credit	($7)

The Taxable Limited Partners are not required to spread any amounts under the financial arrangements rules in respect of the:

- Facility Lease;
- AM&M Phase;
- Construction Agreement; or
- Asset Management and Maintenance Contract.

The amounts that must be spread by the Taxable Limited Partners under the financial arrangements rules in accordance with this determination are:

- interest on the Senior Debt calculated in accordance with the IFRS financial reporting method in s EW 15D;
- payments in respect of the Swaps calculated in accordance with the expected value method in s EW 15F or the IFRS reporting method in s EW 15D; and

- payments in respect of the Letters of Credit calculated in accordance with the IFRS financial reporting method in s EW 15D.

The Taxable Limited Partners must also apply:

- *Special Determination S50: Application of the Financial Arrangements Rules to the D&C Phase of a Public–Private Partnership*; and
- *Special Determination S51: Subordinated Convertible Note in Respect of a Limited Partnership Interest in a Public–Private Partnership*.

This determination is signed by me on the 31st day of October 2016.

Dinesh Gupta
Manager, Taxpayer Rulings

Special Determination S50: Application of the financial arrangements rules to the D&C phase of a public-private partnership

This Determination may be cited as Special Determination S50: Application of the Financial Arrangements Rules to the D&C Phase of a Public-Private Partnership.

1. Explanation (which does not form part of the determination)

1.1 This determination relates to an arrangement (the Project) involving the finance, design, construction and provision of ongoing asset management and maintenance services in respect of the Facility by a limited partnership (the Partnership) under a public–private partnership agreement (the Project Agreement) with the Crown.

1.2 Another limited partnership (Holdings) will hold a 100% interest in the Partnership. Holdings has four limited partners. Limited Partner A is exempt from income tax. Limited Partner B is a limited partnership with multiple limited partners, some of whom are exempt from income tax. Limited Partner C and Limited Partner D are both limited liability companies. Limited Partner C, Limited Partner D, and each limited partner of Limited Partner B that is not exempt from income tax are together referred to as the Taxable Limited Partners. This determination only applies to the Taxable Limited Partners and does not apply to those limited partners that are exempt from income tax.

1.3 The Project Agreement comprises three basic components:

- a design and construction phase (the D&C Phase) under which the Partnership agrees to design and construct the Facility for the Crown in consideration for a fixed lump-sum payment (the D&C Payment), payable on completion of the D&C Phase;
- a Facility Lease to be entered into by the Partnership and the Crown under which the Partnership prepays an amount representing the rental the Partnership will pay to the Crown (the Rental Prepayment); and
- an asset management and maintenance phase (the AM&M Phase) under which the Partnership will provide asset management and maintenance services to the Crown over a 25-year term in consideration for monthly payments (the Unitary Payment).

1.4 The Partnership will enter into:

- a Construction Agreement with a contractor (the Contractor), under which the Contractor will design and construct the Facility in consideration for payments; and
- an Asset Management and Maintenance Contract with a service provider (the Service Provider), under which the Service Provider will provide the asset management and maintenance (and other) services in consideration for payments.

1.5 The Partnership will raise debt (the Senior Debt) from Limited Partner A and various third-party financiers. The Partnership will enter into interest rate swaps in respect of the Senior Debt (the Swaps).

1.6 Holdings will also receive funding during the D&C Phase from:

- Limited Partner A and Limited Partner B in the form of convertible debt instruments (the Convertible Notes); and
- Limited Partner C and Limited Partner D in the form of deferred equity contributions backed by letters of credit (the Letters of Credit).

1.7 The Facility Lease, AM&M Phase, Construction Agreement, and Asset Management and Maintenance Contract are all excepted financial arrangements as defined in s EW 5. The D&C Phase, Senior Debt, Swaps, and Letters of Credit are financial arrangements as defined in s EW 3. The Project, including all of these agreements, is a wider financial arrangement. *Special Determination S49: Application of the Financial Arrangements Rules to a Public–Private Partnership* applies to the arrangements in the wider financial arrangement, other than the D&C Phase and the Convertible Notes. *Special Determination S51: Subordinated Convertible Note in Respect of a Limited Partnership Interest in a Public–Private Partnership* applies to the Convertible Notes.

1.8 This determination prescribes:

- the portion of the D&C Payment treated as income under the financial arrangements rules (the Interest Component); and
- the method for spreading that income over the term of the D&C Phase.

2. Reference

This determination is made under ss 90AC(1)(bb), 90AC(1)(d) and 90AC(1)(i) of the Tax Administration Act 1994.

3. Scope of determination

3.1 This determination applies to the Partnership in respect of the D&C Phase of the Project Agreement, under which the Partnership agrees to design and construct the Facility for the Crown and will receive a fixed lump-sum payment (the D&C Payment) once the Facility is ready for operation.

3.2 Limited Partner B, Limited Partner C and Limited Partner D use IFRSs to prepare financial statements and to report for financial arrangements.

3.3 The Taxable Limited Partners will recognise income derived from the Crown during the D&C Phase of the Project Agreement and deduct expenditure incurred in relation to the Construction Agreement under the relevant provisions of the Income Tax Act 2007 (outside of the financial arrangements rules).

3.4 This determination is made subject to the following conditions:

- The design and construction costs of the Facility are agreed between the Partnership and the Crown on an arm's length basis and set out in the Base Case under the Project Agreement as referenced to in the definition of "Design and Construction Payment" in Clause 1.1 of the Project Agreement.
- Private rulings BR Prv 16/64 and BR Prv 16/65 issued on 31 October 2016 continue to apply (under s 91EB of the Tax Administration Act 1994).

4. Principle

4.1 During the D&C Phase, the Partnership will receive consideration from the Crown (in the form of the D&C Payment) and will in turn provide consideration to the Crown (in the form of the completion of the Facility, including the transfer of the rights set out in clause 11.2 of the Project Agreement). The D&C Phase is a "financial arrangement" under s EW 3 and an "agreement for the sale and purchase of property or services" under s YA 1.

4.2 The Partnership and the Crown have agreed that the D&C Payment includes capitalised interest (clause 12.5(c) of the Project Agreement). The Interest Component of the D&C Payment will be income under the financial arrangements rules in subpart EW.

4.3 During the D&C Phase the Partnership will accrue variable expenditure commitments. The capitalised interest component of the D&C Payment is intended to offset the expected funding costs incurred in relation to these commitments.

4.4 The Interest Component is calculated with reference to expected funding costs. No adjustment is made for variances between actual and expected costs as the D&C Payment, including capitalised interest, is agreed in advance.

4.5 The Interest Component needs to be spread over the term of the D&C Phase.

5. Interpretation

In this determination, unless the context otherwise requires:

- All legislative references in this determination are to the Income Tax Act 2007, unless otherwise stated.
- **IFRS** means a New Zealand Equivalent International Financial Reporting Standard in effect under the Financial Reporting Act 2013, and as amended from time to time or an equivalent standard issued in its place.

6. Method

Calculation of the interest component of the D&C Payment

6.1 The value of the completed Facility (including the transfer of the rights under clause 11.2(c) of the Project Agreement) is the agreed design and construction costs of the Facility (excluding Fitout) set out in the Base Case under the Project Agreement.

6.2 The D&C Payment, less the agreed design and construction costs of the Facility (excluding Fitout) set out in the Base Case under the Project Agreement, is the Interest Component that is income under the financial arrangements rules.

6.3 Private Ruling BR Prv 16/65 rules on the portion of the D&C Payment that is not income under the financial arrangements rules and is not considered in this determination.

Spreading of the interest component of the D&C Payment

6.4 The method for determining the amount of income that is to be allocated to each income year is as follows:

(a) The expected design and construction costs of the Facility (excluding Fitout) as set out in the Base Case are treated as having been incurred at the beginning of each of the income years that make up the D&C Phase (the Annual Expenditure). No adjustment will be made to the Annual Expenditure in any income year to reflect actual expenditure in that year.

(b) The interest allocated to each income year is then calculated in accordance with the following formula:

Interest = OB × R

Where:

OB is the sum of the Annual Expenditure for that income year, plus the Annual Expenditure and interest attributable to any previous income year.

R is the internal rate of return (based on annual resets) calculated using the notional cash flows in para (a) above at the beginning of each income year as outflows, and the D&C Payment at the end of the D&C Phase as the only inflow.

7. Example

This example illustrates the application of the method set out in this determination.

The Partnership and the Crown agree under the Base Case that the D&C Payment equals $250,000.

The Base Case sets out that the agreed design and construction costs of the Facility (excluding Fitout) are to be $240,000. This is value of the completed facility (including the transfer of the Partnership's rights as set out in clause 11.2 of the Project Agreement).

The Interest Component of the D&C Payment is $10,000 by implication of the valuation under this determination.

The Taxable Limited Partners will spread the Interest Component over the term of the D&C Phase of the Project Agreement, as follows:

The Annual Expenditure incurred and treated as having been incurred at the beginning of the relevant income year is as follows:

Years	Actual D&C costs
1	($31,000)
2	($77,000)
3	($130,000)
4	($2,000)
D&C Payment	$250,000
	($240,000)

Based on receipt of the $250,000 D&C Payment in Year 4, the Project has an internal rate of return of 1.5980%.

The Interest Component is therefore spread as follows:

Years	Actual D&C costs	Cumulative	Interest income
1	($31,000)	($31,000)	$495
2	($77,000)	($108,495)	$1,734
3	($130,000)	($240,229)	$3,839
4	($2,000)	($246,068)	$3,932
D&C Payment	$250,000	$250,000	
	($240,000)		$10,000

This determination is signed by me on the 31st day of October 2016.

Dinesh Gupta
Manager, Taxpayer Rulings

LEGISLATIONS AND DETERMINATIONS

Special Determination S51: Subordinated convertible note in respect of a limited partnership interest in a public-private partnership

This determination may be cited as Special Determination S51: Subordinated Convertible Note in Respect of a Limited Partnership Interest in a Public–Private Partnership.

1. Explanation (which does not form part of the determination)

1.1 This determination relates to the issue of subordinated convertible notes (Convertible Notes) by a limited partnership (the Partnership) to two of its limited partners (Limited Partner A and Limited Partner B – the Subscribers). The Convertible Notes will convert to a 40% partnership interest (for each of the Subscribers) at a single, or several, nominated date(s) in the future to match the partnership contributions by the other two limited partners in the Partnership (Limited Partner C and Limited Partner D).

1.2 Limited Partner A is exempt from income tax. Limited Partner B is a limited partnership with multiple limited partners, some of whom are exempt from income tax. Limited Partner C and Limited Partner D are both limited liability companies. Limited Partner C, Limited Partner D, and each limited partner of Limited Partner B that is not exempt from income tax are together referred to as the Taxable Limited Partners. This determination only applies to the Taxable Limited Partners and does not apply to those limited partners that are exempt from income tax.

1.3 The Convertible Notes will earn a fixed rate of interest that is payable monthly (Coupon Interest Payments) until the Convertible Notes are converted or repaid. The Coupon Interest Payments will be capitalised on each interest payment date. However, the additional Convertible Notes issued in satisfaction of the interest payments will not convert to a partnership interest, but will be repaid to the Subscribers over multiple distribution dates.

1.4 The interest rate on the Convertible Notes will be a market rate determined under an agreed rate-set process. No fees are payable by the Partnership or the Subscribers in relation to the Convertible Notes.

1.5 In accordance with s EW 6(2) an amount that is solely attributable to an excepted financial arrangement is not taken into account under the financial arrangements rules. An interest in a partnership is an excepted financial arrangement under s EW 5(11). Therefore, the Convertible Notes are a financial arrangement that includes an excepted financial arrangement.

1.6 This Determination prescribes the method for determining the amounts that are solely attributable to the excepted financial arrangement, as well as the method for spreading the income and expenditure under the financial arrangements rules.

2. Reference

This determination is made under ss 90AC(1)(bb), 90AC(1)(d) and 90AC(1)(h) of the Tax Administration Act 1994.

3. Scope of determination

3.1 This determination applies to the Convertible Notes issued by the Partnership to the Subscribers as part of a wider transaction entered into by the parties, which is the subject of Private Rulings BR Prv 16/64 and BR Prv 16/65, issued on 31 October 2016.

3.2 The terms of the Convertibles Note are as follows:

(a) The Convertible Notes will be drawn in full at Financial Close and will have a face value equal to 40% (for each of the Subscribers) of the total equity requirement.

(b) The Convertible Notes will earn a fixed rate of interest that is capitalised monthly until conversion or repayment (the Coupon Interest Payments).

(c) The Coupon Interest Payments that are capitalised on each interest payment date will not convert to a partnership interest, but will be paid out to the limited partners over multiple partnership distribution dates.

(d) The interest rates payable to Limited Partner A and Limited Partner B under the convertible notes do not exceed the arm's length rates that would have been agreed between wholly unrelated parties having regard to the terms of the convertible notes and applying orthodox pricing methodologies.

(e) No fees are payable by the Partnership or the Subscribers in relation to the Convertible Notes.

4. Principle

4.1 The Convertible Notes are a financial arrangement (as defined in s EW 3). An interest in a partnership is an excepted financial arrangement (s EW 5(11)). Therefore, the Convertible Notes are a financial arrangement that includes an excepted financial arrangement.

4.2 Under s EW 6(2), an amount that is solely attributable to an excepted financial arrangement is not taken into account under the financial arrangements rules.

4.3 Any amount that is not solely attributable to an excepted financial arrangement is required to be taken into account under the financial arrangements rules and spread in accordance with those rules.

4.4 Under s EW 14(3), an amount calculated for and allocated to an income year under a spreading method will either be expenditure incurred or income derived by the person.

4.5 *Determination G1A: Apportionment of Income and Expenditure on a Daily Basis* sets out a method for calculating and allocating income and expenditure on the basis of daily apportionment.

5. Interpretation

In this determination, unless the context otherwise requires:

- All legislative references in this determination are to the Income Tax Act 2007, unless otherwise stated.
- **Convertible Notes** means the unsecured subordinated notes, in a denomination of $1.00 issued by the Partnership to the Subscribers.
- **Coupon Interest Payment** means the monthly interest payable on the Convertible Notes in accordance with their terms.
- **IFRS** means a New Zealand Equivalent International Financial Reporting Standard in effect under the Financial Reporting Act 2013 and as amended from time to time or an equivalent standard issued in its place.

6. Method

6.1 Any change in the market value of the interest in the Partnership between the issue date of the Convertible Notes and conversion into the partnership interest will be solely attributable to the excepted financial arrangement.

6.2 The Coupon Interest Payments are not solely attributable to an excepted financial arrangement, and therefore must be spread under the financial arrangements rules. There will be no other amounts of income or expenditure under the financial arrangements rules in relation to the Convertible Notes.

6.3 Under s EW 14(3), the Coupon Interest Payments will be expenditure incurred by the Taxable Limited Partners and income derived by the limited partners of Limited Partner B that are not exempt from income tax.

6.4 Income and expenditure in respect of the Convertible Notes will be calculated by daily apportionment of the Coupon Interest Payment to income years in accordance with *Determination G1A: Apportionment of Income and Expenditure on a Daily Basis*.

7. Example

This example illustrates the application of the method set out in this determination.

On 1 April 2017, Convertible Notes are issued to the Subscribers for $1,000. The Convertible Notes will mandatorily convert to a 40% interest in the Partnership for each Subscriber on 31 March 2022.

The Coupon Interest Payments will be set at the market interest rate of 8.5% and will be capitalised on each monthly interest payment date.

The annual sum of Coupon Interest Payments as at 31 March from 2018 to 2022 is:

31 March 2018	$88.39
31 March 2019	$96.20
31 March 2020	$104.71
31 March 2021	$113.96
31 March 2022	$124.04
	$527.30

On the date of issue, the market value of a 40% partnership interest in the Partnership is $1,000. Any change in the market value between the date of issue and 31 March 2022 will be solely attributable to an excepted financial arrangement.

The amounts that must be spread under the financial arrangements rules are the Coupon Interest Payments, which shall be apportioned using the method outlined in *Determination G1A: Apportionment of Income and Expenditure on a Daily Basis*.

This determination is signed by me on the 31st day of October 2016.

Dinesh Gupta
Manager, Taxpayer Rulings

LEGAL DECISIONS – CASE NOTES

This section of the *TIB* sets out brief notes of recent tax decisions made by the Taxation Review Authority, the High Court, Court of Appeal, 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.

District Court declines to set aside debt judgment on basis of alleged unfairness

Case	Commissioner of Inland Revenue v Ronald Maxwell Wilson [2016] NZDC 20012
Decision date	25 October 2016
Act(s)	District Court Rules 2014,
Keywords	Tax Administration Act 1994
	Set aside judgment debt, *Russell v Cox*, r 15.10 of the District Court Rules Act 2014, ss 6, 109, 120D and 120I of the Tax Administration Act 1994.

Summary

The defendant unsuccessfully applied to set aside a judgment of debt obtained by the Commissioner of Inland Revenue ("Commissioner"). The District Court declined to set aside the judgment on the basis that the defendant had no reasonable grounds of defence and could not establish that a miscarriage of justice had occurred.

Facts

The defendant applied to set aside a debt judgment given on 17 June 2015 (and later sealed) in favour of the Commissioner in the sum of $137,303.10.

The Commissioner's claim was in respect of goods and services tax ("GST"), late payment penalties and interest. The proceedings in respect of the claim were filed on 2 December 2014 and were served on the defendant on 24 January 2015.

No statement of defence was filed by the defendant and subsequently the Commissioner sought default judgment by way of formal proof pursuant to r 15.9 of the District Court Rules 2014 ("DCR"). The matter was listed for a formal proof hearing on 25 May 2015 and notice was sent to the defendant regarding the date of the hearing.

On 25 May 2015, the defendant appeared in person and asserted that he had not been served with the proceedings and disputed the amount claimed. The hearing was adjourned until 27 June 2015.

On 27 June 2015, the defendant conceded that the proceedings were properly served on him but sought a further adjournment to see whether settlement could be reached between the parties. This was declined and judgment was entered for the Commissioner.

On 15 June 2016, the defendant applied to set aside the judgment asserting that he had a substantial ground of defence that he could now prove.

Decision

The Court declined the defendant's application to set aside on the grounds that he did not have a reasonable ground of defence.

The Court referred to DCR 15.10 which provides that a judgment by default may be set aside or varied by the court if it appears that there has, or may have been, a miscarriage of justice. The Court cited *Russell v Cox* [1983] NZLR 654 and said that in determining the Court's overriding consideration of the interests of justice, the Court will generally consider: whether the defendant's failure to file a statement of defence was excusable; whether the defendant had a substantial ground of defence; and whether the plaintiff would suffer irreparable injury if the judgment was set aside.

The defendant's tax liability arose out of a GST debt owed by a trust of which the defendant was a trustee; the defendant is liable as a trustee for the unpaid GST debt of the trust pursuant to s 57 of the Goods and Services Tax Act 1975 (sic). In 2003, the core amount of GST owed by the defendant was $17,693.65. This amount has remained unpaid since July 2003 and with the addition of penalties and interest, the liability increased over the 12 year period until judgment to a sum of $137,303.10.

Citing s 109 of the Tax Administration Act 1994 ("TAA") which states that disputable decisions are deemed correct except in challenge proceedings, the Court held that the defendant had no defence to his claim in relation to the core tax liability.

In relation to the interest component of the defendant's claim, the Court cited ss 120D and 120I of the TAA, which state that a taxpayer is liable to pay interest on unpaid tax in accordance with Part 7 of the TAA (s 120D) and a taxpayer may not object to or challenge the imposition of interest payable under Part 7 (TAA, s 120I).

The defendant accepted that he could not challenge the core tax liability or the interest liability. However the defendant referred to the Commissioner's obligations under s 6 of the TAA and argued that it was not fair for the Commissioner to seek to recover the amount claimed (particularly in relation to the interest) because IRD "sat on its hands" for 6 years before seeking judgment. The Court noted that the Commissioner did not accept the allegation and asserted the Commissioner had been endeavouring to resolve the defendant's tax issues during that time.

The Court found that in assessing the defendant's liability the Commissioner was doing exactly what the law required. The defendant was attempting "by back door means" to judicially review an administrative action in the District Court, which is outside the jurisdiction of the District Court and has very limited application in relation to tax. In any event, the Court considered the argument had no merit as "fairly" in the context of s 6 does not relate to a "taxpayer's subjective concepts of fair play". Rather the Commissioner is required to act lawfully and carry out her lawful duties fairly and impartially between taxpayers and "according to law".

The Court cited *TRA No 95/086* (1996) 17 NZTC 7,534 (TRA), where Judge Barber stated that "[t]he Commissioner's role…is not to act fairly, it is to act lawfully by taking from each taxpayer no more and no less than is that person's lawful obligation to pay."

High Court confirms tax avoidance and opening of time bar on basis of returns being wilfully misleading

Case	Great North Motor Company Limited (In Receivership) v Commissioner of Inland Revenue
Decision date	11 November 2016
Act(s)	Companies Act 1993; Income Tax Act 2007; Tax Administration Act 1994
Keywords	Section 330 of the Companies Act, Tax Avoidance, Time Bar, Wilfully Misleading, ss BG 1, DB 7 of the Income Tax Act 2007; ss 108, 141D, 149A(1) Tax Administration Act 1994, Abusive Tax Shortfall Penalty.

Summary

Great North Motor Company Limited ("Great North") commenced challenge proceedings against the Commissioner of Inland Revenue ("Commissioner") in respect of the Commissioner's assessments in the income tax periods 31 March 1996 to 2011. The High Court upheld the Commissioner's assessments.

Facts

Great North was incorporated on 21 October 1959 and until 7 February 1992 was called Zupps Motors Ltd. It operated a used car yard. 99.99 per cent of the plaintiff's shares are held by Glen Eden Holdings Ltd ("Glen Eden"). Glen Eden is wholly owned by Commercial Management Ltd ("Commercial Management"). Commercial Management is wholly owned by Commercial Administration Ltd ("Commercial Administration") and Commercial Administration is wholly owned by Glen Eden. The remaining 0.01 per cent of Great North is owned by Downsview Nominees Ltd ("Downsview") and Downsview is wholly owned by Commercial Administration. The Court noted that Great North's ownership "may be fairly described as circular".

Mr John George Russell was the sole director of Glen Eden, Commercial Management and Commercial Administration as well as accountant and secretary to all three companies.

Mr Radisich and his companies are longstanding clients of Mr Russell and Mr Radisich is a former shareholder of Great North (he held 98.4 per cent of the shares until September 1998). All shares in Great North are held on trust for Mr Radisich's benefit.

On 20 August 1993, Great North issued a debenture to Glen Eden in return for Glen Eden advancing $380,277 to Great North. This sum was repayable "on demand"; meaning Great North was liable to repay the advance in full at any time. Interest was payable at any rate specified by Glen Eden, but only when Glen Eden actually demanded payment of interest. In the absence of Glen Eden stipulating an interest rate, the default rate was 28 per cent per annum. Under the debenture, Great North was entitled to make repayments of principal at any time. At that time, Great North was insolvent. It had ceased trading on 10 December 1993, some four months after Glen Eden had injected the funding. The Court considered it likely however that these funds were used to repay a creditor (Ron West Ltd, of which 99.99 per cent of the shares were owned by Mr Radisich and the remaining 0.01 per cent by Downsview).

On 14 July 1994 Mr Russell wrote to the Commissioner saying Great North had no assets or income, and thus no funds to pay PAYE tax deductions from 31 March 1991. Mr Russell corresponded similarly on 21 March 1995. Great North was placed in liquidation, in the intervening period, on 1 September 1994.

On 20 April and 28 June 1995, Mr Russell filed income tax returns for Great North for that year. The returns asserted that Great North had made combined losses of $1,785,076.12. Great North was removed from the companies register on 8 May 1996. However, it was restored to the register on 1 July 1997 on application by Glen Eden and Mr Russell.

On 23 December 1997 Mr Russell wrote two letters to the Commissioner outlining objections to the Commissioner's 1991 to 1995 determinations. In April 1998, Great North instituted judicial review proceedings against the Commissioner in relation to these determinations. However, Great North did not recommence business and was again placed in liquidation on 24 June 1998. Glen Eden (the shareholder) abandoned its judicial review proceedings in September 1998.

On 25 May 2005 Kensington Developments Ltd ("KDL") acquired 14 debentures from Glen Eden, including that issued by Great North to Glen Eden in 1993.

KDL was incorporated in 1979 but has been in receivership since 30 June 1994. Mr Russell has been its receiver from July 1994 and sole director from 1 April 2008. The Court considered it was unlikely KDL paid anything to acquire the debentures yet Great North now owed KDL (by virtue of the transfer) $5.9 million under the debenture. On 26 May 2005, Mr Russell appointed himself receiver of Great North. On 29 May 2005, Great North was struck off the companies register.

In July 2005 Mr Russell filed tax returns on behalf of Great North even though the company had been removed from the register two months earlier. The returns were for the tax years ending 31 March 1996 to 31 March 2005 inclusive and claimed expenditure and associated losses made up of the interest payable on Great North's debenture since inception (which by 2005 had reached $7,206,855.66).

On 13 July 2006 Mr Russell filed Great North's return for that year (with losses of $8,875,561.97). Computer generated determinations were automatically issued allowing the claimed expenditure and losses. From 11 October 2005, the Commissioner issued re-assessments disallowing the expenditure and losses.

The Court considered it "almost certain" that Mr Russell had anticipated the Commissioner's re-assessments as:

1. On 27 August 2010 Mr Russell and Glen Eden applied to reinstate Great North to the companies register, and it was reinstated from 8 October 2010;
2. On 5 January 2011 Mr Russell filed tax returns for 2007–2009; and
3. On 10 January 2011 in response to a letter from the Commissioner, Mr Russell informed the Commissioner that her re-assessments were time-barred because of the operation of s 330 of the Companies Act 1993.

Over 2011 and 2012 Mr Russell filed Great North's tax returns for the 2010–2011 years. On 7 April 2011, the Commissioner commenced an investigation into Great North's returns and sought information from Mr Russell. The parties continued corresponding into 2012.

On 4 September 2012 KDL transferred (at least some of) its interest in the debenture to Timberton Investment Ltd ("Timberton"). Timberton is wholly owned by Mr Radisich. Mr Russell signed the deed of assignment as receivers for both Great North and KDL. Timberton paid KDL a total of $600,000 (albeit the Court noted that Mr Russell had accepted this was paid to use up Great North's tax losses). Great North agreed to pay contributory interest as necessary at a rate of 10 percent per annum. Timberton acquired Great North's tax losses at a rate of 15 cents per dollar of loss.

In 2014, the Commissioner concluded that Great North had engaged in tax avoidance and s 108(2) of the Tax Administration Act 1994 ("TAA") permitted re-assessments to be made.

Decision

Before considering each issue in turn, the Court firstly noted that Mr Russell's evidence was unpersuasive.

Tax avoidance

The Court confirmed that the specific provisions were satisfied but found that the arrangement was a tax avoidance arrangement.

The Court considered that Great North had issued debentures to Glen Eden when it knew it was insolvent, the debenture terms reinforced the artificiality of the arrangement and the debenture was later transferred to KDL without consideration. The Court noted that the ownership of the relevant entities was circular and there was no genuine economic consequence for Great North or KDL or even Timberton.

The Court considered that the arrangement was artificial and contrived with creditors being replaced to alter the incidence of tax. The Court concluded that Parliament would not have contemplated the deduction of interest as a business-related expense in this way.

Time bar: s 108 of the TAA

The Court concluded that for the purposes of s 108(2) of the TAA, Mr Russell knew the returns he completed and filed on behalf of Great North were misleading on the basis that, either, he had actual knowledge the arrangement constituted tax avoidance or that it was highly likely tax avoidance (and therefore subjectively reckless).

Shortfall penalty

The Court found that the tax position taken by Great North was unacceptable and abusive and was therefore satisfied that the Commissioner did not err in imposing shortfall penalties for an abusive tax position.

Time bar: s 330 of the Companies Act 1993

The Court considered that it is clear from s 15 of the Companies Act 1993 that once removed from the register a company does not exist in law. However, the Court accepted that s 330 of the Companies Act 1993 (as demonstrated by the relevant case law) provides that the actions of a deregistered company are not treated as nullities upon the company's restoration to the register. Accordingly a return can be retrospectively validated.

However, the Court considered that validation does not backdate the return to the time of filing:

1. Until restoration there is no taxpayer with whom the Commissioner can deal and therefore until restored, the deregistered company cannot defend itself by complying with the applicable statutory time period;
2. Sections 328(6) and 329(4) of the Companies Act 1993 seek to ensure that neither the restored company nor any other person is unfairly affected by the company's removal from the register and that s 330 should be read alongside those powers; and
3. Section 108 strikes a balance between the finality of taxpayer affairs and the effective maintenance of the tax base and "unbridled retrospective validation" of a tax return under s 330 of the Companies Act 1993 could imperil s 108 of the TAA. The Court said that, if it was a live issue, it would have concluded that the time bar commenced only when Great North was restored to the register on 8 October 2010.

Court confirms two step approach for hardship applications

Case	Singh v Commissioner of Inland Revenue [2016] NZHC 3001
Decision date	12 December 2016
Act(s)	Sections 6, 6A, 176, 177, 177A, 177C Tax Administration Act 1994
Keywords	Judicial review, hardship relief, two step approach, non-compliance

Summary

The Commissioner of Inland Revenue ("the Commissioner") must now undertake a two-step approach when considering an application for financial relief on the grounds of serious hardship. Inland Revenue ("IR") must determine first whether the payment of tax would result in the taxpayer suffering hardship and then, second, go on to make a decision on whether to write off the tax owed. It is only at the second step that the Commissioner may have regard to the taxpayer's compliance history.

Impact

The Judgment's impact:

1. An IR officer is allowed to make a recommendation to the decision maker as long as the decision maker makes the actual decision whether to grant serious hardship relief.
2. The Commissioner must outline to a taxpayer seeking relief the areas of concern and give the taxpayer a reasonable opportunity to provide explanations for those issues.
3. The Court has confirmed the two step approach when considering applications for financial relief on the grounds of serious hardship: one, whether the payment of tax will result in the taxpayer suffering serious hardship: two, if serious hardship is established whether to write off the outstanding tax. The taxpayer's history of compliance or non-compliance can only be taken into account in the second step.

Facts

Mr and Mrs Singh ("the Applicants") were substantially indebted to the Commissioner for outstanding income tax and goods and services tax ("GST") and claimed they had no means of meeting judgments the Commissioner has obtained against them in respect of their tax liabilities.

On several occasions between January 2014 and 2015, they unsuccessfully sought financial relief from paying their tax debts on the grounds of serious hardship. This led them to file judicial review proceedings and, before the substantive hearing, the Commissioner agreed to reconsider her decision.

Richard Philp, delegation holder, reconsidered the decision and declined the application. He advised them of this by letter dated 13 May 2016 and the Applicants continued with their judicial review.

The Applicants amended grounds of review were that the reconsideration process was unfair, in breach of the principles of natural justice, failed to take into account relevant considerations and took into account irrelevant considerations.

Decision

Before considering each issue, the Court turned to the relevant legislative provisions for granting hardship. The Court confirmed that s 6A (3) of the Tax Administration Act 1994 ("TAA") prescribes the Commissioner's general duty to collect taxes, noting the importance of compliance and voluntary compliance by taxpayers. The Court followed by detailing ss 176, 177, 177A and 177C of the TAA in how hardship provisions are to be applied.

Section 176 of the TAA deals with the Commissioner's obligations to recover outstanding tax from individual taxpayers. A taxpayer may request financial relief against liability by making a request under s 177. Section 177A prescribes the manner in which the Commissioner is required to decide whether a taxpayer's request for financial relief on the grounds of serious hardship should be granted. If the Commissioner concludes that relief should be granted, she may write off all or part of the tax owed by the taxpayer; s 177C.

The Court noted that s 177C (1BA) of the TAA took effect from 1 July 2014 and changed the law in relation to financial relief for serious hardship in one significant aspect. Under the previous legislation the Commissioner was obliged to grant relief where payment of the outstanding tax would result in serious hardship but under the new wording of s 177C (1BA), the Commissioner may use serious hardship as a basis upon which to grant relief but is not required to do so. The Court confirmed the decision in *P v Commissioner of Inland Revenue* [2015] NZHC 2293 that the Commissioner must now undertake a two-step approach when considering an application for financial relief on the grounds of serious hardship. The Commissioner must determine, first, whether the payment of tax would result in the taxpayer suffering hardship and then, second, go on to make a decision on whether to write off the tax owed. It is only at the second step that the Commissioner may have regard to the taxpayer's compliance history.

Did the Commissioner conduct the reconsideration process in a manner that breached the principles of natural justice?

Appointment of Mr Philp as delegated decision maker

Mr Weaver, counsel for the Applicants, argued that the Commissioner should not have appointed Mr Philp to make the ultimate decision as he understood that Ms Miranda Law would be making the decision and would have objected to Mr Philp. The submission was effectively an allegation of bias and the Court found there was no basis for any suggestion that Mr Philp was disqualified on the grounds of actual or apparent bias.

Inconsistency in approach

The Applicants' submission was that the Commissioner was wrong to depart from earlier decisions in which delegated IR officials had accepted that the Applicants' would suffer serious hardship if they were required to pay the outstanding tax. This submission, however, overlooked the fact that Mr Philp based his reconsideration on information supplied by the Applicants for the reconsideration and Mr Philp was entitled to reach a different conclusion.

No fresh reconsideration

The Applicants argued that Mr Philp did not make a fresh decision, and merely "rubber stamped" or endorsed the earlier decisions to deny relief. The Court dismissed this submission noting that Ms Law, Recovery and Enforcement Specialist, carried out a thorough analysis of the material provided by the Applicants and Mr Philp made his own decision based on that material.

Failure to provide Mr and Mrs Singh a proper opportunity to be heard

The Applicants argued that they should have had a greater opportunity to explain issues that were of concern. The Court accepted that the Commissioner was under an obligation to deal fairly with the Applicants which meant the Commissioner identifying areas of concern and giving the Applicants a reasonable opportunity to provide explanations for those issues.

The Court concluded that the Commissioner met her obligations when she wrote to Mr Weaver outlining issues and areas of concern regarding the hardship application. The principal issue was the absence of evidence relating to expenditure on living expenses and this issue was clearly put to the Applicants. They, via their accountant, provided an explanation that their son was providing the necessary funds to meet their living expenses and presented bank statements to support this. The bank statements did not support the explanation given and the Commissioner was not required to go back and point out that the explanation was not supported by the material provided.

Failure to give reasons

There was no basis for an allegation that Mr Philp failed to give reasons for the reconsideration decision. His letter to the Applicants dated 13 May 2016 comprised two pages setting out the reasons why he had declined the application.

Fettering discretion/abdication of authority

There was no basis for the submission that Mr Philp effectively abdicated his authority. Although Ms Law and others made recommendations to Mr Philp, the evidence clearly established that it was Mr Philp who made the actual decision regarding the application.

Did the Commissioner fail to take into account relevant information?

Failure to take into account inability to make mortgage payments

Mr Weaver submitted that the Commissioner failed to take into account the fact that the Applicants were unable to make mortgage repayments.

The Court did not consider that this submission was correct. Ms Law clearly took the issue into account in her recommendation to Mr Philp. Although Mr Philp did not refer to the issue expressly in his letter of 16 May, he obviously read Ms Law's memorandum and must have taken the issue into account.

Justice Lang noted that the real issue was whether the Applicants had the ability to access sources of income that they had not disclosed as those sources of income may have been able to meet the mortgage arrears as well as their living expenses.

Alleged suppression of income

Mr Weaver submitted that both Ms Law and Mr Philp referred to the possibility that the Applicants had undisclosed income and that neither were qualified to make that decision. The Court disagreed.

The bank statements provided contained no expenditure that could be attributed to household living expenses and did not support the assertion their son was supporting them. The absence of evidence leads to the logical conclusion they were meeting those expenses by some means that is yet unknown.

Did the Commissioner take into account irrelevant information?

Mr Weaver submitted that Mr Philp took into account the Applicants' history of non-compliance when determining the issue of serious hardship.

This allegation could not be sustained as the issue of the Applicants' history of non-compliance was in the section of Mr Philp's letter in which he explains why he would not exercise the discretion in favour of the Applicants even if they had established serious hardship. The Commissioner is entitled to take into account the prior history when exercising the discretion whether to grant relief (the second step).

Court of Appeal upholds High Court decision declining an application for discovery of material exchanged pursuant to a Double Taxation Agreement

Case	Chatfield & Co Limited v Commissioner of Inland Revenue [2016] NZCA 614
Decision date	16 December 2016
Act(s)	Sections 17 and 81 of the Tax Administration Act 1994, ss 69 and 70 of the Evidence Act 2006, s 10(2)(i) of the Judicature Amendment Act 1972
Keywords	Discovery – Exchange of Information – Double Taxation Agreement

Summary

The Appellant brought an appeal against a decision of the High Court declining an application for discovery of material ("the Documents") exchanged pursuant to a Double Taxation Agreement ("DTA") between New Zealand and the Republic of Korea. The Court of Appeal agreed with the High Court that the documents were not required to be discovered but differed from the High Court on the basis for that decision. The Court considered that the documents for which discovery was sought had not been shown to be relied on by the Appellant, or to adversely affect its case or to adversely affect or support another party's case. Accordingly the Court of Appeal considered that there was no basis for the making of a discretionary order for discovery and dismissed the appeal.

Facts

The Appellant appealed against a decision of the High Court declining an application for discovery of material ("the Documents") exchanged pursuant to the DTA.

The decision of the High Court was reflected by judgments of Ellis J dated 1 September 2015 (*Chatfield & Co Ltd v Commissioner of Inland Revenue* [2015] NZHC 2099, (2015) 27 NZTC 22-024) and 9 June 2016 (*Chatfield & Co Ltd v Commissioner of Inland Revenue* [2016] NZHC 1234, (2016) 27 NZTC 22-053), and by minute of Ellis J dated 19 May 2016 (*Chatfield & Co Ltd v Commissioner of Inland Revenue* HC Auckland CIV-2015-404-1013 19 May 2016).

The substantive proceeding in which the application for discovery was advanced is an application for review of decisions made by the Commissioner to issue notices to the Appellant under s 17 of the TAA for information held on various parties for whom the Appellant was the "tax agent" for the purposes of ss 33 and 34B of the TAA.

The Appellant's substantive litigation originally involved two causes of action. The first was that the Appellant had a legitimate expectation under operational statement OS 13/02 (*Operational Statement: Section 17 notices* Inland Revenue, OS 13/02, 14 August 2013). The second was that the Commissioner failed to consider the terms of OS 13/02, the limited nature of the tax agent/client relationship and the DTA. The first cause of action and the first two limbs of the second cause of action were struck out by Lang J on 27 September 2016 (*Chatfield & Co Ltd v Commissioner of Inland Revenue (No 2)* [2016] NZHC 2289, (2016) 27 NZTC 22-072).

This left the allegation that in making the decision to issue the s 17 notices the Commissioner failed to consider the DTA as the last remaining cause of action.

The strike out decision has also been appealed but had not been heard as of the date of the current appeal. Accordingly, the Court of Appeal was required to proceed on the basis that only one part of the original pleading remains to be argued in the substantive judicial review proceedings.

In the decision under appeal, Ellis J concluded that the only aspect of the pleading to which the Documents would relate (namely the allegation that the Commissioner failed to take into account the DTA) was unlikely to be justiciable and the Documents were not required to be disclosed (*Chatfield & Co Ltd v Commissioner of Inland Revenue* [2016] NZHC 1234, (2016) 27 NZTC 22-053 at [22]).

Decision

The Court of Appeal agreed with the High Court that the documents were not required to be disclosed; although on a different basis. As a result the Court of Appeal dismissed the appeal.

The Court highlighted that discovery in judicial review proceedings is not available as of right. The power of the Court to grant discovery in judicial review proceedings is discretionary and contrasts with the position that applies in an ordinary proceeding.

Since 1 February 2012, the High Court Rules have provided for two kinds of discovery, namely "standard discovery" and "tailored discovery". References in the new rule to the cases of the parties means that relevance will still be a hallmark of what has to be discovered. The relevance of a document for discovery purposes must be assessed having regard to the pleaded claim.

The sole effective pleading, following the strike out by Lang J, was that the Commissioner failed to consider "the DTA, and in particular the terms of Article 25 of Schedule 1 to the DTA".

The Court noted the difficulty that immediately rose for the Appellant is that it is clear that the Commissioner did consider Article 25; it was only by virtue of this Article that the Commissioner was able to issue the notices under s 17 of the TAA.

The Court was not persuaded by the Appellant's attempts to particularise the last remaining cause of action at hearing and did not consider it was enough to support a discovery order under s 10(2)(i) of the Judicature Amendment Act. In light of this, the Court of Appeal considered that the application indicated that the Appellant was "fishing".

The Court noted the fundamental point to be made is that the pleading as it stands makes an assertion that is apparently incorrect on its face since it is clear the Commissioner did take the DTA into account. There is no basis in the pleading for making a discretionary order for discovery. Whilst there are important issues at stake when the Court is asked to order discovery in a case involving a request made by a foreign state under a DTA, when examined against the last remaining cause of action, the documents for which discovery is sought have not been shown to be relied on by the Appellant, or to adversely affect its case or to adversely affect or support another party's case.

Subdivision, Supply of Land, and Forestry: Taxable Activities?

Case	TRA 024/15 [2016] NZTRA 14
Decision date	25 November 2016
Act(s)	Tax Administration Act 1994 ss 14, 89AB(1), 89C(eb), 89D(1), 89G(1), 113, 114, 138E(1)(e)(iv), 138G Goods and Services Tax Act 1985 ss 6(1)(a), 6(2) New Zealand Bill of Rights Act 1990 s 27
Keywords	New issues/propositions of law, discretion, fraudulent activity, notice, post, courier, PO Box, taxable activity, subdivision, supply of interests in land, forestry

Summary

The Commissioner of Inland Revenue ("the Commissioner") reassessed the disputant, trustee of the X Trust ("the Trust"), disallowing the claim for GST input credits for the period ended 31 July 2009. The disputant challenged this on the following grounds:

1. the Commissioner's decision to not issue a Notice Of Proposed Adjustment ("NOPA") under s 89C(eb) of the Tax Administration Act 1994 ("the TAA") on the basis of fraudulent activity was subject to a precondition of there being "reasonable grounds" for this, which was able to be challenged;
2. the Commissioner's Notice of Response ("NOR") was issued out of time;
3. the Trust was carrying on a taxable activity of subdivision, supply of interests of land and/or forestry;
4. the Trust was carrying on a taxable activity and it was entitled to the claimed input GST credits.

The Taxation Review Authority ("TRA") found that, firstly, the Commissioner's decision to not issue a NOPA under s 89C(eb) of the TAA could not be separated from the existence of reasonable grounds for belief in fraud, and so could not be challenged.

Even if it could be, any failure by the Commissioner here would not be fatal. Secondly, notice of the Commissioner's NOR was given when a notification card was placed in the disputant's PO Box. Thirdly, the Trust was not engaged in a taxable activity. Fourthly, as the Trust had not been found to be carrying on a taxable activity, it was unnecessary to consider whether it was entitled to the claimed GST input credits.

Impact

The judgment confirms that the Commissioner's exercise of her discretion under s 89C(eb) of the TAA is not subject to the right of challenge and that the existence of reasonable grounds to believe that the disputant has been involved in fraudulent activity is a matter left solely to the Commissioner. There is no basis for separating the decision not to issue a NOPA from the existence of the reasonable grounds.

The judgment also provides useful analysis of s 14 of the TAA (as it was then), clarifying that when notice is given by post under s 14(8), the deeming provision in s 14(9) applies unless there is evidence of actual delivery, in which case notice is given upon arrival.

Although specific to the facts of this case, the judgment provides interesting discussion on what tasks or course of conduct are required to constitute taxable activity. On the facts here, passively allowing planted trees to grow does not constitute the taxable activity of forestry and continuously awaiting the outcome of legal proceedings and the normal activities associated with purchasing land and land ownership do not constitute the taxable activity of subdivision.

Facts

The disputant (trustee of the Trust) challenged the Commissioner's reassessment denying the disputant's claim for input tax credits for the taxable period ended 31 July 2009 ("the disputed period").

In or about 1992, one of the disputant's companies purchased a block of land which had been used for forestry purposes. In subsequent years the land was subdivided, and in 2002 a certificate of title was issued for the property which was approximately 6.7419 hectares ("the property"). The property was then transferred between various entities related to the disputant.

The Trust was created by deed in January 2009 and was registered for GST. In March 2009 the disputant entered into a sale and purchase agreement to buy the property from Mr B, an associate of the disputant, with a possession date of 22 May 2009. The purchase price was $600,000 inclusive of GST (if any). In August 2009 the Trust filed a GST return for the disputed period and claimed a total input tax credit of $67,011.65 (including $66,666.67 on the purchase of the property).

During the period the property was owned by the Trust, the computer freehold register records that the property was transferred back and forth between trustees. The property was eventually sold to third parties in late September 2010.

Prior to the sale of the property in September 2010, a corporate trustee of the Trust granted a forestry right to itself for a term of 30 years at a consideration of $1.00 and provided an option for the grantee or nominee to purchase the grantor's interest in the forestry block for $10.00.

At about the same time, an encumbrance was granted by the corporate trustee to itself which obliged the corporate trustee to establish a sustainable forestry management plan and/or vegetation and weed management plan. Both the forestry right and the encumbrance were then sold to entities related to the disputant for $40,000 each (GST inclusive). The GST on these transactions was returned in the disputant's GST return.

Preliminary matters

There were two new issues raised by the disputant in his notice of claim and submissions:

1) Whether the reassessing officer lacked delegated authority to exercise any power or discretion under s 89C(eb) of the TAA and/or to make the reassessment so that the reassessment is invalid; and
2) Whether the Commissioner disregarded her obligations under s 27 of the New Zealand Bill of Rights Act 1990 ("NZBORA") by making an unfair finding that the disputant was involved in fraudulent activity and/or not allowing the disputant to be heard in respect of s 89C(eb) so that the reassessment is a nullity.

In relation to both issues, the TRA concluded that these were matters that could have easily been raised in the disputant's statement of position and as she considered the requirements of s 138G(2) had not been met, she declined the applications to allow these issues to be raised at the hearing. Further, the TRA considered that there was no basis on which a breach of s 27 of the NZBORA could be argued as the de novo nature of the hearing before the Taxation Review Authority cures any alleged breaches of process by the Commissioner and/or any irregular conduct.

Decision

Whether the Commissioner was entitled to exercise her discretion under s 89C(eb) of the Tax Administration Act 1994?

The issues raised by the disputant in relation to the Commissioner's exercise of her powers under s 89C(eb) of the TAA were summarised as:

1) Whether the Commissioner had reasonable grounds to believe the trust was involved in fraudulent activity;
2) Whether s 89C(eb) provides grounds to refuse a refund of GST.

The TRA did not accept the disputant's argument that although the Commissioner's decision not to issue a NOPA cannot be challenged by the operation of s 138(1)(e)(iv) of the TAA, the issue as to whether or not the Commissioner had reasonable grounds to believe the taxpayer had been involved in fraudulent activity could still be the subject of a challenge. In the Judge's opinion, the purpose of the section was clear and unambiguous: the Commissioner's exercise of her discretion under s 89C(eb) is not subject to the right of challenge and therefore the existence of reasonable grounds to believe that the disputant had been involved in fraudulent activity is a matter left solely to the Commissioner.

In relation to the second question, the TRA did not accept the disputant's argument that the Commissioner wrongly made her reassessment pursuant to s 89C(eb) and accepted the Commissioner's contention that the assessment was amended using s 113 of the TAA.

Moreover, the TRA concluded that even if there had been a breach of s 89C(eb) by the Commissioner, the assessment would not have been invalidated due to s 114 of the TAA. The disputes process could still have continued, notwithstanding the Commissioner's failure to issue a NOPA; in this case, the disputant did issue a NOPA and the dispute and claim proceeded in the usual fashion.

Whether the Commissioner's Notice of Response was issued within time?

There was a factual dispute about when the disputant's NOPA was issued. If the disputant's evidence was accepted, the Commissioner's NOR would have been issued out of time. However, the TRA did not accept the disputant's evidence on this issue and concluded that the Commissioner's NOR was required to have been issued and notified to the disputant by 2 November 2012.

The only address given by the disputant for the Trust was a post office box address. The Commissioner couriered her NOR to the AB Superette and Post Centre ("the Superette"), which operated as a shop and postal service outlet. The envelope was addressed for the attention of the disputant followed by the name of the Trust. The physical address of the Superette was then given as the particular courier company did not deliver to post office box addresses. The envelope containing the NOR was delivered to the Superette at 10.40am on 2 November 2012. The evidence of the Superette manager was that usual procedure was for the courier package or a yellow card to be placed into the post office box "straight away". In this case, a yellow card was placed in the disputant's post office box.

The TRA did not accept that delivery to a post office box is sufficient to satisfy the requirements of s 14(5) of the TAA under which the Commissioner could give notice by personal delivery to an addressee that is not a corporate body.

The TRA then considered s 14(8) of the TAA that enables the Commissioner to give notice by post and the postal deeming provision in s 14(9). In *Commissioner of Inland Revenue v Sea Hunter Fishing Limited* CA 142/01, 13 December 2001, the Court of Appeal said that notice is deemed to have been received when in the normal course of post it would have been delivered, however, if the notice actually arrives faster than the normal course of post it would be given upon arrival (at [21]).

The TRA concluded that there was no reason to believe that the usual practice was not followed by the Superette manager in respect of this delivery and she was satisfied that the yellow card was placed in the post office box immediately after the courier delivered the envelope on 2 November 2012. The Judge did not find any particular relevance in the fact that the envelope did not include the disputant's post office box number, as the Superette manager's evidence was that there was a list of post office box holders and the disputant was well known at the Superette. Further, the Judge did not place any significance on the fact that a yellow card and not the package itself was placed in the post office box, as this was the usual procedure adopted for post office box holders where the package is oversize and/or a signature is required.

The TRA concluded that notice had been given when the yellow card advising the disputant that a package was held for collection was put into the post office box, which she found had occurred within the response period.

Whether the Trust was carrying on a taxable activity?

Section 6 of the GST Act 1985 defines "taxable activity" and the TRA noted that the law is well settled. There are four requirements which must be met under s 6(1) of the GST Act.

Firstly, there must be an activity. "Activity" is a broad concept involving a combination of tasks undertaken or a course of conduct pursued by a taxpayer. An activity cannot be entirely passive.

Secondly, the taxable activity must be "carried on continuously or regularly" and whether the test is satisfied is a question of fact and degree.

Thirdly, a taxable activity must involve, or intend to involve, the supply of goods or services to another person. Where no supplies have been made, the assertion of an intention to supply can be tested against the objective evidence.

Fourthly, the supply or intended supply of goods and services must be made for consideration.

The TRA noted that whilst s 6(2) of the GST Act treats anything done in connection with the beginning of a taxable activity as being carried out in the course of the taxable activity, the provision does not create a taxable activity where one would otherwise not exist. Section 6(2) merely "adds" the commencement activity to the taxable activity.

The disputant contended that the Trust's taxable activities were (i) subdivision; (ii) supply of interests in land; and (iii) forestry.

Subdivision

The TRA found that of the particular activities undertaken by the Trust in relation to subdivision, some of these were the usual tasks related to the purchase of land (arranging finance and instruction of lawyers) and other tasks related to ownership of the property (installation of water tables and spraying of blackberry). The Judge held that work done by the disputant on matters brought by him as trustee of other trusts or representing other entities was not relevant for the present purposes. In relation to other tasks (such as photocopying and research for a Court of Appeal hearing in July 2009, preparing a claim against the territorial authority for alleged breaches of its statutory duties under the Resource Management Act, continuously chasing up resource consent applications and continuously waiting on the outcome of appeal proceedings before the Environment Court) the TRA held that the Trust was not a party and consequently had no active involvement in these matters.

The TRA noted that no subdivision work of any nature was carried out on the property. In her opinion, the tasks identified were simply not sufficient to amount to carrying on the activity of subdivision.

Supply of interests in land

The TRA concluded that there was no evidence of any combination of tasks or course of conduct being undertaken by the Trust in relation to supply of interests in land. A quid pro quo proposal that was under consideration by the Environment Court did not proceed, and the granting of the forestry right and encumbrance (which the Judge noted were unusual transactions) and the sale of the property occurred well outside the disputed period. The TRA concluded that there was no evidence before the Authority that the Trust carried out any activity related to the supply of interests in land during the disputed period and that at best it could be said that the trust had identified such supply as a potential activity and was waiting on other events to occur.

Forestry

The property comprised of planted pinus radiata and native regeneration. The TRA concluded that during the relevant period the pinus radiata trees were simply left to grow, were not pruned or otherwise maintained and no other forestry activity was undertaken. The Judge accepted the Commissioner's argument that doing nothing other than letting the trees already planted on the property continue to grow is not sufficient to constitute the taxable activity of forestry.

The TRA accepted the evidence of the Commissioner's forestry expert that native regeneration does not constitute forestry unless there is under planting of commercial species and there was no evidence that this had been done. She also determined that holding the property awaiting the outcome of proceedings in the Environment Court as to whether the *quid pro quo* proposal would be implemented did not amount to carrying on the activity of forestry.

If the Trust was carrying on a taxable activity, whether the Trust is entitled to the input tax deductions claimed in the disputed GST period?

As well as the input tax credit claimed for the purchase of the Property, the Trust also claimed other relatively small amounts in its 31 July 2009 GST return including for telephone, photocopying, power and computer repairs. The TRA held it was not necessary for her to consider this issue as she had concluded that the Trust was not carrying on a taxable activity.

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