Inland Revenue
Te Tari Taake

TECHNICAL DECISION SUMMARY > ADJUDICATION

WHAKARĀPOPOTO WHAKATAU HANGARAU > WHAKAWĀ

Income tax: Timing of income and expenditure

Decision date | Rā o te Whakatau: 25 August 2022

Issue date | Rā Tuku: 3 April 2023

TDS 23/03

Subjects | Kaupapa

Income tax: When did the Taxpayer derive the maintenance component of the lease income? When was the Taxpayer entitled to deduct the maintenance expenditure?

Abbreviations | Whakapotonga

The abbreviations used in this document include:

CCS	Customer & Compliance Services, Inland Revenue
ITA 2007	Income Tax Act 2007

Taxation laws | Ture tāke

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

Facts | Meka

Introduction

1. The Taxpayer carried on a business which involved leasing assets to customers under lease contracts (the **leases**). The Taxpayer was obliged to maintain the leased assets in good repair and operating condition during the terms of the leases.
2. When the Taxpayer determined the amount it would charge under the leases, it calculated two main components:
   - the lease of the assets (**lease component**), and
   - the maintenance costs the Taxpayer expected to incur during the term of the agreement (**maintenance component**).
3. The terms of the leases did not break the contract price down into those components. Instead, each lease contract provided for the payment of a single sum which was described in the leases as **rental**.

Accounting treatment of income from the leases

4. For accounting purposes, the Taxpayer applied NZ IFRS 15 when reporting the income it earned under the leases. Prior to adopting NZ IFRS 15, the Taxpayer recognised all of the rental under the leases in the accounting period to which the rental related.

5. In the application of NZ IFRS 15 to the leases, the Taxpayer considered the maintenance component was a distinct revenue stream and the performance obligations it carried out in relation to this revenue were the maintenance responsibilities it had under the leases. Therefore, during the terms of the leases, the Taxpayer recognised the maintenance component of the rental under the leases to the extent that it had incurred expenditure meeting its maintenance obligations.

6. As to the lease component, the Taxpayer recognised this in the accounting period to which it related.

Tax treatment of income from the leases

7. In its tax returns for the years in dispute the Taxpayer recognised the rental in the period to which it related (as it had prior to adopting NZ IFRS 15 for accounting purposes). The Taxpayer subsequently disputed its self-assessments and proposed to adjust the tax treatment to align with the accounting treatment under NZ IFRS 15.

Matters in dispute

8. The Taxpayer argued the rental under the leases was not derived until it "came home" and this occurred when the Taxpayer's income earning process was complete.[1]

9. As applied to the maintenance component, the Taxpayer argued its income earning process involved the provision of maintenance services. The Taxpayer considered this process was only completed to the extent that the Taxpayer had performed its maintenance responsibilities under the leases. Further, the Taxpayer considered the appropriate measure for determining the extent to which the Taxpayer's maintenance responsibilities had been performed was the amount of expenditure that the Taxpayer incurred carrying those responsibilities out.

10. The Taxpayer argued in the alternative that, if it was wrong and the maintenance component of the rental under the leases was derived on a current year basis, it was

[1] *Arthur Murray (NSW) Pty Ltd v FCT* (1965) 114 CLR 314; *CIR v Mitsubishi Motors New Zealand Limited* (1994) 16 NZTC 11,099 (CA).

entitled to deduct maintenance expenditure up to the value of the maintenance component derived in each income year.[2]

11. CCS argued that the correct view of the contractual arrangements the Taxpayer entered into under the leases was that no part of the rental was payment for maintenance services. That is:

- The rental was entirely a payment for the provision of fully maintained assets for a set term.
- There was no basis for deferring recognition of the maintenance component in the manner argued by the Taxpayer.

12. CCS also rejected the Taxpayer's alternative argument on the ground that it would involve the Taxpayer obtaining deductions for maintenance expenditure it had not incurred.

Issues | Take

13. The primary issue is when does the Taxpayer derive the maintenance component of the rental. To establish this the Tax Counsel Office addressed the following sub-issues:

- What was the nature of the process by which the Taxpayer earned its income and when was the process complete?
- What was the correct characterisation of the arrangements that the Taxpayer entered into under the leases?
- What was the relevance of the accounting treatment that the Taxpayer adopted under NZ IFRS 15 when it prepared its accounts?

14. The alternative issue was when does the Taxpayer incur the maintenance expenditure?

15. In addition, the onus and standard of proof were dealt with as a preliminary issue.

Decisions | Whakatau

16. The Tax Counsel Office decided the adjustments proposed by the Taxpayer should not be made because:

[2] *CIR v Mitsubishi Motors New Zealand Limited* (1995) 17 NZTC 12,351 (PC).

- The Taxpayer derived the rental under the leases when and to the extent that it had met its contractual obligation to supply assets in good repair and operating condition and was entitled to issue an invoice for the supply.
- The Taxpayer did not incur the maintenance expenditure at the time the leases were entered into. The Taxpayer incurred expenditure when the services the expenditure was payment for were provided.

Reasons for decisions | Pūnga o ngā whakatau

Preliminary issue | Take tōmua: The onus and standard of proof

17. The onus of proof in civil proceedings[3] is on the taxpayer, except for shortfall penalties for evasion or similar act, or obstruction.[4] The taxpayer must prove that an assessment is wrong, why it is wrong, and by how much it is wrong.[5]

18. The standard of proof in civil proceedings is the balance of probabilities.[6] This standard is met if it is proved that a matter is more probable than not.

19. The onus of proof rests with the Commissioner to show that a taxpayer is liable for a shortfall penalty for evasion under s 141E of the TAA.[7] This is different from the other shortfall penalties where the onus of proof is on the taxpayer. The standard of proof is the balance of probabilities.[8]

[3] Challenge proceedings (ie, the proceedings that would follow if a dispute proceeds to a Taxation Review Authority or a court) are civil proceedings.

[4] Section 149A(2) of the TAA.

[5] *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271 (CA); *Beckham v CIR* (2008) 23 NZTC 22,066 (CA).

[6] Section 149A(1) of the TAA; *Yew v CIR* (1984) 6 NZTC 61,710 (CA); *Birkdale Service Station Ltd v CIR* (1999) 19 NZTC 15,493 (HC); *Case X16* (2005) 22 NZTC 12,216; *Case Y3* (2007) 23 NZTC 13,028.

[7] Section 149A(2) of the TAA.

[8] Section 149A(1) of the TAA.

Issue 1 | Take tuatahi: When does the Taxpayer derive the maintenance component of the rental?

The parties' rights and obligations

20. Under the terms of the leases the Taxpayer was responsible for all repairs, labour costs and materials necessary to keep the assets in good repair and operating condition. The effect of this was that scheduled and unscheduled maintenance was the Taxpayer's responsibility and at the Taxpayer's cost. Consequently, the Tax Counsel Office considered that the carrying out of scheduled and unscheduled maintenance did not involve the provision of maintenance services to the Taxpayer's customers. It followed that the rental under the leases was entirely payment for the provision of the assets which the Taxpayer was under an obligation to keep in a state of good repair and operating condition, and not to any extent payment for maintenance services provided by the Taxpayer.

Income earning process

21. The tax consequences of a transaction turned on the legal arrangements entered into and carried out by the parties to the transaction, and not by reference to some other economically equivalent arrangement the parties may have entered into but chose not to.[9] In addition, the true nature of a transaction is determined by the contract that embodies the transaction.[10] For this purpose the approach to be taken when interpreting a contract is an objective one.[11]

22. Therefore, the Tax Counsel Office considered it was not permissible to treat the rental under the leases as though it were, in part, prepayment for services when it was in legal substance a payment for the provision of an asset in good repair and operating condition. Under the accruals method of income recognition income was earned when a person's income earning process was complete. It followed that the Taxpayer's income earning process was complete when and to the extent that it had met its

[9] *Buckley & Young Ltd v CIR*.

[10] *Firm PI 1 Ltd v Zurich Australian Insurance and Body Corporate 398983* [2014] NZSC 147, (2014) 10 NZBLC 99-716. See also *Vector Gas Ltd v Bay of Plenty Energy Ltd* [2010] NZSC 5, (2010) 9 NZBLC 102,874 and *Pendarves Packaging Ltd v Baitworx Ltd* [2014] NZHC 3,327, (2015) 1 NZBLC 99–718.

[11] The approach to contract interpretation was no different in tax cases. In *CIR v John Curtis Developments Ltd* [2014] NZHC 3,034, 26 NZTC 21-113 Kos J said that for tax purposes the contract underlying a transaction must be construed in the ordinary way.

contractual obligation to supply an asset in good repair and operating condition and it was entitled to issue an invoice for the supply.

Contingency of repayment

23. In *Arthur Murray* the Court found that prepayments for dancing lessons were not derived when received because there was a possibility they might have to be paid back by way of damages should the dancing lessons not be provided.[12] The Taxpayer argued that *Arthur Murray* applied to the maintenance component because the Taxpayer might have to repay the maintenance component if it did not meet its maintenance obligations and was successfully sued for damages. However, unlike the fees in *Arthur Murray*, the maintenance component was not a prepayment for services. As such, *Arthur Murray* was not authority for the view that the maintenance component was subject to a contingency of repayment in the event the Taxpayer was successfully sued for damages.

Mitsubishi (CA)

24. The Taxpayer relied on the Court of Appeal decision in *Mitsubishi* (***Mitsubishi* (CA)**).[13] In *Mitsubishi* (CA) customers purchased a car that came with the benefit of a warranty against defects. Although customers obtained two things under their sale contracts (a car and a warranty), the contract price was expressed to be a payment for a car only. The Court of Appeal found that it was permissible to apportion a part of the sale price to the warranty. In *Mitsubishi* (***Mitsubishi* (PC)**) the Privy Council rejected this approach.[14] Lord Hoffman said that if Mitsubishi had made a separate charge for the warranty there would be no difficulty in treating that income as earned over the warranty period rather than at the moment of sale. However, there was no justification in the accounting evidence for retrospectively treating part of the sum agreed to be the price of a car as if it had been a separate charge for a warranty.

25. The Taxpayer argued that the Privy Council's decision in *Mitsubishi* (PC)) was distinguishable because Mitsubishi did not have a sound basis for identifying the amount of income that related to the warranties. However, the Tax Counsel Office considered that this argument was incorrect because the Taxpayer's customers did not obtain maintenance services. Therefore, although it was possible to calculate the maintenance component, there was nothing under the contractual arrangements that

[12] *Arthur Murray (NSW) Pty Ltd v FCT* (1965) 14 CLR 314 (HCA).

[13] *CIR v Mitsubishi Motors New Zealand Ltd* (1994) 16 NZTC 11,099 (CA).

[14] *CIR v Mitsubishi Motors New Zealand Limited* (1995) 17 NZTC 12,351 (PC).

this amount could be apportioned to. For this reason, there was no basis for the type of apportionment contemplated by the Privy Council in its judgment in *Mitsubishi* (PC).

The accounting evidence

26. The Courts have held that financial reporting standards and commercial accounting practice have some relevance in determining when income is derived but they are not determinative and will always be subject to the statutory scheme and the most appropriate approach for income tax purposes.[15]

27. The approach under tax law principles to determining the time at which the maintenance component was derived was different from the approach that the Taxpayer adopted when determining the extent to which the maintenance component should be recognised for accounting purposes under NZ IFRS 15.

28. As such, the Taxpayer's accounting treatment was inconsistent with relevant tax law principles. Therefore, as a taxpayer's accounting treatment was not determinative and was subordinate to the most appropriate tax law treatment (if inconsistent with that treatment), the Taxpayer's approach under NZ IFRS 15 did not support the tax treatment that it proposed in relation to the rental under the leases.

The commercial context

29. The Taxpayer argued its position was consistent with the commercial reality of the arrangements under the leases. However, as the tax consequences of a transaction turn on the legal arrangements actually entered into and carried out, the Taxpayer's approach could not be adopted for assessment purposes, even if it was thought to be consistent with the underlying commercial reality of the lease arrangements.

30. In any event, there was a measure of consistency between the commercial and legal substance of the lease transactions. The apparent commercial purpose of the leases was to provide customers with a leasing option under which responsibility for repairing and maintaining a leased asset remained with the Taxpayer. To this end the Taxpayer scheduled those activities (in so far as they could be planned), paid for them, and took responsibility for approving designated servicing agents. Conversely, the customer paid a single amount of rental for the hire of an asset and to the extent that the customer had any maintenance responsibilities, it met those responsibilities at its own cost. These matters went to the commercial reality of the leases and were consistent with the legal substance of the transactions, in that:

[15] *Horizon Homes Limited v CIR* (1994) 16 NZTC 11,064 (HC) at 11,069-11,070.

- the rental the customers paid under the leases was consideration for the hire of an asset in good repair and operating condition, and
- the rental was not to any extent a payment for maintenance services.

Issue 2 | Take tuarua: When is the Taxpayer entitled to deduct the maintenance expenditure?

31. As noted above at [10], the Taxpayer argued in the alternative that, if it was wrong and the maintenance component of the rental under the leases was derived on a current year basis, it was entitled to deduct maintenance expenditure up to the value of the maintenance component derived in each income year.

When does the Taxpayer incur the maintenance expenditure?

32. Under *Mitsubishi* (PC), expenditure was incurred if there was an existing legal obligation to make a payment in the future and the obligation was one to which the person was definitively committed. The Taxpayer considered that it incurred maintenance expenditure at the time the lease was entered into because that was the time at which it became liable to carry out scheduled and unscheduled maintenance, and the cost of meeting that liability could be reliably estimated. The Taxpayer placed reliance on similarities between:
    - its maintenance responsibilities, and
    - the warranty arrangements in Mitsubishi (PC) and free servicing arrangements which are discussed in Interpretation Statement "*Meaning of Incurred – The Privy Council Decision in the Mitsubishi Case Interpretation Statement* – IS3533".
33. Although there were similarities, there were also material differences. Vendors of assets under free servicing and warranty arrangements supplied services to the purchasers of the assets because the purchasers owned the assets. In contrast, when the Taxpayer carried out scheduled and unscheduled maintenance it was not providing services to its customers under the leases because it did not have a contractual obligation to do so. Instead, the Taxpayer's obligation was to provide an asset that was in good repair and operating condition. Since the Taxpayer was not contractually liable to provide repair and maintenance services, it was not possible to conclude that at the time a lease was entered into, an obligation to make payments meeting such liability had accrued. Consequently, the Tax Counsel Office considered the facts of the present matter were distinguishable from the material facts in *Mitsubishi* (PC) with the result that the Taxpayer's argument could not succeed.

Scheduled and unscheduled maintenance

34. There were additional circumstances that supported a conclusion the Taxpayer's maintenance responsibilities did not constitute an existing obligation to carry out scheduled and unscheduled maintenance at the time a lease was entered into:

Scheduled maintenance:

- It was implicit that the Taxpayer was not under a contractual obligation to its customers to perform each item of scheduled maintenance. This was supported by the fact the Taxpayer's maintenance obligation was to maintain each asset in good repair and operating condition.
- It followed that there was no underlying legal obligation on the Taxpayer to perform the scheduled maintenance to which it could be said the Taxpayer was definitively committed (*Mitsubishi* (PC)).

Unscheduled maintenance:

- If a part in a leased asset failed prematurely, any failure by the Taxpayer to replace the part could constitute a breach of the Taxpayer's obligation to ensure the asset was kept in good repair and operating condition. However, this did not show that the cost of replacing the part was incurred at the time the lease was entered into. For that to be the case, the Taxpayer's liability to replace the part must have been in existence at that time. This would require that the defective part was in the asset at the time the lease was entered into with the consequence that the asset was not in a state of good repair and operating condition.
- However, it had not been shown this was the case. The leases were typically entered into for a number of years, in contrast to the warranty period in *Mitsubishi* being limited to 1 year or 20,000km. Further, the Taxpayer had not provided any evidence to justify its assertion that any unscheduled maintenance arose due to defects that were inherent in the assets on the day the leases were entered into.
- It followed that in the context of unscheduled maintenance the Taxpayer had not satisfied the burden of proving that asset parts requiring replacement were inherently defective at the time the leases were entered into.

Matching of income and expenditure

35. If the Taxpayer was treated as being under an obligation to provide repair and maintenance services at the time a lease was entered into, the end result would be inconsistent with the reasoning in *Mitsubishi* (PC). *Mitsubishi* (PC) was concerned with

the matching of expenditure and income. The costs that vendors under warranty and free servicing arrangements paid to meet their obligations to purchasers related wholly to sales income that was derived in the year of the sale. Matching of that nature would not occur if the costs the Taxpayer paid carrying out scheduled and unscheduled maintenance were treated as incurred in the year an applicable lease was entered into. This was because the income that was payable under the leases arose over the term of the lease and not only in the year the lease was entered into. This was a further point of distinction from *Mitsubishi* (PC).

Section EA 3

36. Although it was concluded that the Taxpayer did not incur maintenance expenditure when it entered into the leases, it was observed that if this conclusion was incorrect and it was found that the Taxpayer did incur the maintenance expenditure at that time, s EA 3 would likely apply to the expenditure.

37. Section EA 3 applies when a person has been allowed a deduction for expenditure and the expenditure is unexpired at the end of the person's income year. Expenditure on services is unexpired at the end of an income year if the services have not been performed by the end of the year. Therefore, as the maintenance expenditure was expenditure that would be paid in the acquisition of services from third parties, the maintenance expenditure would be unexpired at the end of any income year to the extent that the services for which the expenditure was payment have not been provided.

38. Section EA 3 requires a person to add the unexpired portion of their expenditure at the end of an income year to their income for the year and then allows the person to claim the portion as a deduction in the following year. In practical effect, therefore, the Taxpayer would be required to defer its deduction for the maintenance expenditure to the year or years in which the services to which the expenditure relates were performed.