RECENT DETERMINATIONS MADE BY THE COMMISSIONER

Six determinations were issued by the Commissioner on the 4th of December 1989. Below is a short explanation of each. The full determinations are printed in the appendix to this TIB item.

DETERMINATION G1A:

This determination replaces Determination G1, made by the Commissioner on 13 May 1989. This determination was necessary to adjust the method of day counting prescribed to that which the Hewlett Packard Business Calculators use.

DETERMINATION G7B:

This determination replaces Determination G7A, made by the Commissioner on 11 May 1989. This determination is required to approve option contracts traded on the New Zealand Futures Exchange. A further futures contract (Three Year Government Stock Futures Contract) has also been added.

DETERMINATION G9A:

This determination replaces Determination G9, made by the Commissioner on 28 July 1988. This determination has been extended to allow its use in determining income and expenditure in respect of deferred property settlements in a foreign currency, for the purposes of a forthcoming determination.

DETERMINATION G18:

This determination approves certain overseas markets, and sources of information, in respect of futures and options traded on overseas exchanges.

DETERMINATION G19:

This determination allows taxpayers who are not in the business of dealing in exchange traded options to use a market valuation method calculated in accordance with this determination. This determination only applies to those options traded on the markets approved in Determinations G7B, and G18.

DETERMINATION E5:

This determination applies in respect of the income year commencing on 1 April 1989. This determination differs from Determination E4 by adding mandatory accounting costs, and accrual expenditure that is deductible under section 165 of the Act, to the schedule of expenditure which need not comply with section 104A of the Act. Amounts have also increased by 10% from Determination E4.

INTEREST ON USE OF MONEY

Statements of account will be produced at the end of January 1990 for taxpayers, advising them of what their current liability is, and what is to be paid by 7 February 1990. The figure shown will only include interest to date, it will not calculate a person's interest liability up until 7 February 1990.

If a practitioner has calculated up to 7 February 1990 for their client and they in turn pay it to the Department prior to the 7 February 1990 then a small credit may remain on the client's account. It will not be the Department's policy to credit or transfer these small balances. However, if requested the credit balance can be transferred by districts manually.

Where small amounts have been charged, i.e. $0.10, they will only be written off when the overall balance is $2 or less.

PROVISIONAL TAX RECALCULATIONS

Persons who have recalculated their provisional tax, with the introduction of the Resident Withholding Tax Legislation, will have received statements showing the new Provisional Tax figure as "estimated", due to computer problems.

Persons re-estimating solely as a result of the introduction of the Resident Withholding Tax will not be subject to the interest and underestimation penalties normally incurred from the estimation method for Provisional Tax.

The Department will be amending these accounts to show the provisional tax as "recalculated". As there is no change in the account balance the Department will not be issuing amended statements.

FIRE LOSSES - SECTION 108 INCOME TAX ACT 1976

SUMMARY

This item is to clarify the correct treatment for tax purposes on expenditure incurred in respect of fire losses.

BACKGROUND

Section 108(1) of the Income Tax Act 1976 restricts section 104 in that it limits the deduction for the repair of certain assets used in the production of assessable income. The deduction is limited to the amount which would normally be spent in any year on those repairs unless an express provision exists elsewhere in the Act to allow the additional expense.

The first proviso to section 108 allows a deduction for:

- depreciation on premises caused by fair wear and tear.

- depreciation on plant, machinery, equipment or a temporary building caused by fair wear and tear or by the asset becoming obsolete or useless.

and which in either case the depreciation cannot be made good by repair.

Under the second proviso, the Commissioner can allow a deduction for repairs or alterations that do not increase the capital value of the asset being repaired or, if they do increase the value of the asset, the amount of the increase is less than the cost of the repairs or alterations.

FIRE LOSSES

The tax treatment of fire losses is discussed in Technical Rulings, Chapter 6, Part 1, Para 6.1.2.

Rulings state that the "losses to buildings, plant, etc., caused by or resulting from a fire (including cost of repairing fire damage) are not due to fair wear and tear or obsolescence and are not deductible for taxation purposes."

The losses rulings are referring to here are those involving destruction of the asset.

Although the conclusion reached is correct, the reasoning is not.

The question of deductibility of fire losses must be considered under the second proviso to the section.

For repairs or alterations to be deductible, they do not have to result from "fair wear and tear" or by reason of the asset becoming "obsolete or useless." This test applies for depreciation purposes under the first proviso to section 108.

Fire losses, where an asset is destroyed, will by necessity involve a replacement. Replacement of an asset involves something more than just an alteration to that asset. The cost of any replacement does not qualify for a deduction being a capital outlay.

Partial damage to an asset due to fire where the asset can be repaired may be considered under the second proviso to the section. Each case will need to be examined to ensure no improvements are involved.

INSURANCE RECOVERIES

Insurance proceeds, indemnity charges or compensation payments received in respect of certain assets lost, destroyed or damaged are taken into account virtually as sale proceeds for an asset sold. Losses on buildings, other than temporary buildings, continue to be treated as capital losses, and insurance recoveries are not taken into account for income tax purposes.

CONCLUSION

Expenditure incurred on fire losses, where the damage incurred necessitates a full replacement of the asset, cannot be regarded as repairs or alterations and is therefore not deductible under the second proviso to section 108. Where there is only partial damage to the asset, and repairs are undertaken, the deduction for those repairs will be considered on a case by case basis.

Please cross reference this circular to Technical Rulings Chapter 6, Part 1, Para 6.1.2 "fire losses"

Reference: HO 10.R.7.1

ACCRUAL RULES ON NEW RESIDENTS

SUMMARY

This item refers to persons becoming New Zealand residents and the impact of the accrual accounting rules contained in the Income Tax Act on such persons.

BACKGROUND

The question has been asked that when a person, who has interests in financial arrangements, becomes a New Zealand resident, are all financial arrangements required to be valued under section 64J(2)(c), even if some of those financial arrangements were acquired prior to an "implementation date", as defined?

RULING

Section 64(J)(2)(c) requires that when:

- a holder or an issuer of a financial arrangement becomes a New Zealand resident the person shall be deemed to acquire or to issue the financial arrangement at the time at which the person becomes a New Zealand resident ...

- and that acquisition ... shall be deemed to have been made for a consideration that might reasonably be expected for the acquisition if the acquisition had been made at arms length.

Section 64(J)(2)(c) is however subject to the limitation as provided in section 64M. That is if the person acquired the financial arrangement prior to an "implementation date", then that financial arrangement is not subject to sections 64B to 64L.

Reference: HO 10.A.3.0

THE TREATMENT UNDER THE ACCRUAL REGIME OF A MARSHALL CLAUSE

SUMMARY

This item deals with the treatment under the Accrual regime (sections 64B to 64M of the Income Tax Act 1976) of a "Marshall" clause where a settlor has a right to demand interest but does not exercise the right. The following matters are discussed:

- Does section 64C(1) apply to interest which may be payable under a Marshall clause?
- Is a base price adjustment required where there is a failure to demand interest?
- How is interest which is demanded and paid during a particular income year treated under the accrual rules?
- What effect do the accrual anti-avoidance rules, sections 64I or 64J, have on "Marshall" clauses?

BACKGROUND

What is a "Marshall" Clause?

The term comes from the case of *Re Marshall* [1964] NZLR 905, [1965] NZLR 851 which concerned the effect, for gift duty purposes, of the failure by the settlor (Marshall) of a trust to make demand for interest in due time.

A deed of trust was executed in which Marshall (M) transferred some shares to himself and another as trustees for the benefit of M's nephews and nieces. Contemporaneously with the execution of the trust deed an equitable mortgage was also executed over the shares to secure the unpaid purchase price. The mortgage provided that the trustees should pay interest to M at the rate of 6% per annum on the outstanding purchase price if M made demand for the interest by a specified date in each year.

M failed to make the interest demand in the three years prior to his death. The Commissioner assessed M for gift duty in respect of the interest not demanded.

Gift Duty Provisions

Section 38 *Death Duties Act 1921* defined the term "gift" as -

"a disposition of property without fully adequate consideration in money or money's worth."

Section 39 of the Act defined the term "disposition of property" as, inter alia, -

"... the release, discharge, surrender, forfeiture or abandonment of any debt, contract, or chose in action." It further deemed a debt to be released or surrendered when it had become "irrecoverable or unenforceable by action through lapse of time." The term "debt" was defined to include any pecuniary liability, charge, or encumbrance.

THE ARGUMENTS

The Commissioner relied on two principal submissions.

(i) M's *right to interest* for each year was a debt or a chose in action for the purposes of section 39 which was deemed to be released or surrendered in that it became irrecoverable or unenforceable by action through lapse of time.

(ii) M's *right to demand interest* was a chose in action for the purposes of section 39 which was deemed to be released or surrendered in that it became irrecoverable or unenforceable by action through lapse of time.

THE DECISION

Right to Interest

The Court found that the right to interest was not a debt for the purposes of the gift duty. There is no existing debt for the interest component until the demand has been made for the interest to be paid. A distinction exists between an absolute and a conditional liability to pay interest. The right to interest, in this case, was a conditional liability which is not a legal liability until the contingency arrived. Until M made the requisite demand for interest the relationship between debtor and creditor did not exist. The giving of the demand in form and manner prescribed in the deed provided a condition precedent to liability on the part of the trustees. Until notice was given there was no right to interest. Rather there was only a right to make a demand.

Right to Make a Demand

The provisions enabling the mortgagee to demand interest created a right in the mortgage. It was a legal right in the strict sense. It was a right of some value which added value to the mortgage if it was purchased by another and this right passed with the mortgage. This right was found to be a chose in action.

The refusal or omission by M to exercise a right to call for interest was held not to amount to a forfeiture of that right within the meaning of the relevant gift duty provision. Forfeiture requires a breach of something in the nature of a duty, obligation, contract, or condition, which results in the loss. In the context of the statute the Court considered that forfeiture is of a positive character requiring an act of will rather than negative acquiescence. Failure to

exercise the right of demand did not amount to a forfeiture.

The next issue the Court considered was whether there had been a release or surrender of the chose in action. The Commissioner considered that as M's right to demand interest was a chose in action it was deemed to be released or surrendered in that it became irrecoverable or unenforceable by action through lapse of time.

The Court did not agree. The Court considered that -

"one cannot properly speak of a right which is only of a limited life and which ceases altogether at the end of its period of time, as being rendered irrecoverable or unenforceable by action through lapse of time. The right is not irrecoverable or unenforceable: it is not one which is alive, having certain circumstances but unenforceable through the Courts; it just does not exist any longer. It is dead."

THE EFFECT OF THE ACCRUAL RULES ON A MARSHALL CLAUSE

Income and Expenditure Calculation

Section 64(C) of the Income Tax Act 1976 sets out the method for spreading accrual income and expenditure. Subsection (1) provides that to calculate the amount of accrual income or expenditure regard shall be had to:

"the amount of all consideration provided to the person and by the person in relation to a financial arrangement."

In a Marshall clause two situations are possible: Interest is demanded or it is not.

Interest not Demanded

Interest which is not demanded or paid under a Marshall arrangement is not an amount of consideration provided by the issuer or to the holder in relation to a financial arrangement. For consideration to pass in a Marshall clause arrangement there must be a debt in existence. In a Marshall clause the debt does not exist unless the demand for interest is made. Prior to the due date for demand it is impossible to stipulate that consideration has been provided to the issuer or holder in relation to the financial arrangement. When the demand is not made on the due date then the debt ceases to exist and accordingly as the consideration will never be forthcoming it can not be said to be "provided".

In the situation where no demand or payment is made by the due date no income has been derived or expenditure incurred for accrual rule purposes in that particular income year.

Interest Demanded

It is clear that in any income year where interest is demanded and paid under a Marshall clause, such interest is part of "the amount of all consideration provided" and therefore must be accrued under section 64C during that income year.

How is this interest to be accrued ?

In the majority of cases it is clear that it is not possible to calculate the amount of income or expenditure of the financial arrangement using the yield to maturity method as prescribed in section 64C(2). In addition the Commissioner has not issued a determination providing a method of accounting for this type of financial arrangement. Section 64C(3)(b) provides, however, that the Commissioner will accept an alternative method of calculation if it:

- conforms with commercially acceptable practice; and

- is adopted and consistently applied by the person for all such financial arrangements for financial accounting purposes; and

- results in the allocation to each income year of an amount that, having regard to the tenor of section 64C(2), is fair and reasonable.

The appropriate allocation is dependent on how the Marshall clause operates. In some circumstances where the demand for interest is infrequent in terms of the length of the loan it is expected that the interest will be brought to account in the income year in which it is paid. There may be other circumstances where interest is frequently demanded. In this situation the interest should be accrued over the whole term of the financial arrangement. In cases of doubt the appropriate financial accounting principle will provide the necessary guidance.

Base price adjustment

Section 64(F) of the Act is designed to ensure that the total economic income or expenditure of a financial arrangement is brought to account for tax purposes. The mechanism used to achieve this is known as the base price adjustment. The adjustment is the calculation performed upon the maturity, transfer or remittance of a financial arrangement, to establish the remaining income or expenditure related to that financial arrangement.

Where, pursuant to a Marshall clause, a person fails to make an interest demand by the due date the issue arises of whether this failure constitutes the "remittance" of the financial arrangement. The term remittance is not defined for the purposes of this part of the Act. However section 64F(1)(c) sets out circumstances in which a financial arrangement is deemed to be remitted. These are -

(i) Where the debtor has been discharged from making all remaining payments under the debt without fully adequate consideration; or

(ii) Where the debtor has been released from the debt due to the operation of the insolvency legislation or by any deed of composition with creditors; or

(iii) The debt is irrecoverable through lapse of time.

The Marshall case makes it clear that a failure to make the interest demand is more in the nature of negative acquiescence rather than positive action. Section 64(F) speaks in the positive for the purposes of the base price adjustment. The maturity, transfer or remittance of a financial arrangement denotes positive action. It is considered that negative acquiescence is not sufficient. Therefore the Department considers that the failure to demand does not constitute the remittance of the financial arrangement at the time the failure occurs.

In the Department's view no base price adjustment is required for the failure to demand the interest by the due date. The base price adjustment calculation is required however upon the maturity, transfer or remittance of the financial arrangement.

ANTI AVOIDANCE PROVISIONS

Sections 64 (I) & (J)

Post Facto Adjustment

Section 64I applies to financial arrangements where the interest and other payments are at the discretion of the parties through the term of the arrangement, which are not generally accepted commercially, and which have the effect of defeating the intent and application of the accrual regime.

An adjustment is required by the parties to recalculate income or expenditure from the arrangement from the time the party issued or acquired it to the end of the income year in which the adjustment is made, on the basis of actual cash flows. The adjustment is required to be calculated in every fifth income year since the issue or acquisition of the financial instrument until disposition.

Non-market Dispositions

Section 64J(1) applies when the parties to a financial arrangement deal with each other on a non-arm's length basis in a manner that has the effect of defeating the intent and application of the accrual regime. It empowers the Commissioner to deem financial arrangements to have been issued, acquired or transferred at market rates.

Marshall Clause

Fundamental to both these provisions is that the effect of the arrangement under review is to defeat the intent and application of the accrual regime. The intent and application is defeated by arrangements which are entered into for the purpose of deferring income or accelerating expenditure. The tests in the sections are objective, motive is irrelevant. An examination of the arrangement is required to ascertain its purpose.

The application of the sections will be on a case by case basis. For instance in cases where an arrangement containing a Marshall clause is entered into for altruistic intra-family dealing and clearly not to defer income or accelerate expenditure then the anti-avoidance provisions will have no application. The sections may apply, however, where a pattern of demanding or not demanding interest clearly establishes the defeat of the intent and application the accruals regime.

TAXPAYER AUDIT PROGRAMME - LINES OF AUTHORITY

SUMMARY

This item explains the new structure of the Taxpayer Audit Programme in Inland Revenue. It also shows who taxpayers should contact if they have complaints regarding the conduct of an investigation or audit.

BACKGROUND

Since 1987, the Inland Revenue Department has undergone major restructuring. The Department's field audit/investigations activity is now grouped under the Taxpayer Audit Programme - consisting of Payroll Inspectors, GST Audit, Verification Unit and the Investigations Unit.

NEW STRUCTURE

The Taxpayer Audit programme has three main levels:

1. Head Office

Taxpayer Audit in Head Office is headed by the Director (Taxpayer Audit) and is concerned with policy matters. There is a small team of Specialist Inspectors who report to the Director.

2. District Office

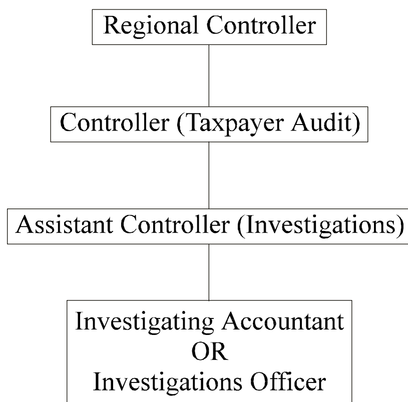
In the District Offices, Payroll Inspectors, GST Auditors and Verification Unit staff all have Supervisors to whom they report directly. The Manager

(Taxpayer Audit) has overall responsibility for the Payroll, GST Audit and Verification Unit programmes and reports to the local District Commissioner.

OPEN POSITION STATEMENT

3. Investigations Unit

The Investigations Unit is structured on a Regional basis. It is managed by the Controller (Taxpayer Audit) who is situated at one of the Department's Regional Offices in Auckland, Hamilton, Wellington and Christchurch. Individual Investigating Accountants and Investigations Officers are situated at the various District Offices of the Department. They report initially to the Assistant Controllers (Investigations), who are located in Whangarei, Auckland, Otahuhu, Hamilton, Napier, New Plymouth, Palmerston North, Wellington, Christchurch and Dunedin.



PROCEDURE FOR COMPLAINTS ABOUT AUDITS AND INVESTIGATIONS

If a taxpayer is unhappy about the way an audit or investigation is being conducted, the matter should first be raised with the officer concerned. If the problem is not resolved, the next point of contact will depend on the type of audit or investigation.

(a) For Payroll Inspectors, GST Audit and the Verification Unit, the relevant Supervisor should be contacted. If the matter cannot be resolved at this level, the local Manager (Taxpayer Audit) should be contacted. If the Manager (Taxpayer Audit) is unable to help, then the next step is the District Commissioner and ultimately the Regional Controller.

(b) For cases involving the Investigations Unit, the appropriate Assistant Controller (Investigations) should be contacted at one of the offices listed above. If the Assistant Controller (Investigations) cannot resolve the matter, it should be referred on to the Controller (Taxpayer Audit) responsible for the officer. If that does not resolve the issue, the Regional Controller may be contacted.

(c) Sometimes an Investigating Accountant or Investigations Officer from one Region will investigate a file in another Region. Depending on the issues involved, the Controller (Taxpayer Audit) responsible for the officer may travel to the other Region to meet with the taxpayer. If discussions with the Controller (Taxpayer Audit) do not resolve the matter, the local Regional Controller may be contacted.

GST ON DISPOSAL OF ASSETS USED PRINCIPALLY IN MAKING EXEMPT SUPPLIES

SUMMARY

This item is to clarify the ruling appearing in Public Information Bulletin 169 and Technical Policy Circular No. 88/31 concerning GST on the disposal assets used principally in making exempt supplies.

BACKGROUND

The ruling on this matter was that the disposal of assets used principally in the making of exempt supplies does not constitute a taxable activity. Instead, it is an activity which is carried on in the course or furtherance of an exempt activity.

CLARIFICATION

An example of such a disposal is that of a bank. The disposal in this case is an extension of the bank's principal activity and is carried on in the course of or furtherance to, an exempt activity, i.e., the supply of financial services under section 14(a) of the GST Act 1985. Therefore no GST liability arises under section 8(1) of the Act. Accordingly, there is no input tax credit available on the purchase of the building nor in respect of the expenses involved in maintaining and developing that building, whilst the principal purpose is the making of exempt supplies. It follows that there should be no output tax liability on the subsequent sale of the building.

However, if the bank was disposing of properties to the extent that the activity became continuous or regular, then these disposals alone could be treated as a taxable activity and a liability for GST would arise on these supplies.

A case has arisen where a local authority has sold land which it had leased and on which prior to sale, the lessees had erected dwellings for the purpose of accommodation.

The activity of freeholding residential land on the scale undertaken by the local authority had been such that it constituted a taxable activity, i.e., "any activity which is carried on continuously or regularly". Also, the sales were made in the course or furtherance of the local authority's taxable activity. Therefore, provided the activity did not involve the provision of exempt supplies, the transactions involved are subject to GST under section 8 of the GST Act 1985.

Section 14(ca) exempts the supply of leasehold land used for the purposes of accommodation. Also exempt is the supply of rental accommodation under section 14(c).

Section 14(d) of the Act exempts from GST the sale of any dwelling by a registered person in the course or furtherance of a taxable activity being a dwelling which has been rented out by that registered person pursuant to section 14(c).

The sale of leasehold land which has been used for accommodation is not specifically exempted under section 14. Therefore, the transactions involved are subject to GST under section 8 of the Act.

Reference: GST. E.3.4

DUE DATES REMINDER

January 20	December Tax Deductions payment due
	FBT Return and payment for quarter ended 31 December due
February 1	GST Return and payment for period ended 31 December due
February 7	First Provisional Instalment due for taxpayers with October Balance Dates
	Second Provisional Instalment due for taxpayers with June balance dates.
	Third Provisional Instalment due for taxpayers with February balance dates.
	Terminal Tax due for taxpayers with March, April, May, June, July, August and September balance dates.
	Self-employed AC levies due.
February 14	Interest and Dividend PAYE due.
	Non-Resident Withholding Tax deductions due.
February 20	January 1990 Tax Deductions due.

TAX INFORMATION BULLETIN NO.7

JANUARY 1990

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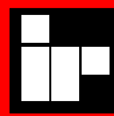

THIS IS AN INLAND REVENUE DEPARTMENT SERVICE
TO PEOPLE WITH AN INTEREST IN NEW ZEALAND TAXATION.

No. 7 JANUARY 1990