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TAX INFORMATION

Bulletin

CONTENTS

1 In summary

3 Legislation and determinations

Determination FDR 2010/02: Use of fair dividend rate method for a type of attributing interest in a foreign investment fund

Categories of taxpayers who need to request a personal tax summary

6 Operational statements

2010 review of the commissioner's mileage rate for expenditure incurred for the business use of a motor vehicle

7 Interpretation statements

IS 10/03: GST: Time of supply – payments of deposits, including to a stakeholder

17 Legal decisions – case notes

High Court finds tax avoidance in an arrangement to develop and sell software

Judicial review: The Commissioner's powers under sections 16 and 16B of the Tax Administration Act 1994

21 Questions we've been asked

QB 09/06: GST – apportionment of the cost of bare land for the purposes of a change-in-use adjustment

QB 10/04: Shortfall penalty for evasion or a similar act – knowledge required and Interpretation Statement IS0062

28 Items of interest

Making tax easier – Government consultation June 9 to 23 July 2010

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YOUR OPPORTUNITY TO COMMENT

Inland Revenue regularly produces a number of statements and rulings aimed at explaining how taxation law affects taxpayers and their agents. Because we are keen to produce items that accurately and fairly reflect taxation legislation and are useful in practical situations, your input into the process, as a user of that legislation, is highly valued.

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

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

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

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

Ref	Draft type/title	Description/background information
XPB0047	Legal services provided to non-residents relating to transactions involving land in New Zealand	This draft public ruling considers the GST position when certain legal services are provided by a registered person to a non-resident person at a time when the non-resident is not present in New Zealand.
XPB0002	Interest repayments required as a result of the early repayment of a financial arrangement – deductibility	This draft public ruling considers the situation when a term deposit arrangement is broken early and a reduced rate of interest is applied from the date of deposit, resulting in the overpayment of interest to the depositor under the term deposit. The depositor is required to repay the overpaid interest and this item considers the deductibility of the interest repaid.

IN SUMMARY

Legislation and determinations

Determination FDR 2010/02: Use of fair dividend rate method for a type of attributing interest in a foreign investment fund 3

This determination concerns New Zealand resident investors' ability to use the fair dividend rate method to calculate foreign investment fund (FIF) income from a type of attributing interest in a FIF. It replaces Determination FDR 2008/01, which is revoked from the 2010–11 income year.

Categories of taxpayers who need to request a personal tax summary 5

The Taxation (Consequential Rate Alignment and Remedial Matters Act) 2009 amended section 33A(5) of the Tax Administration Act 1994, allowing Inland Revenue discretion in selecting who personal tax summaries (PTSs) should be issued to. The means that Inland Revenue may not automatically issue PTSs to groups of customers who previously received them.

Operational statements

2010 review of the commissioner's mileage rate for expenditure incurred for the business use of a motor vehicle 6

Inland Revenue has reviewed the motor vehicle mileage rate reflecting on the average cost of running a motor vehicle, including the average petrol and diesel fuel prices for the 2010 income year, and confirms the current mileage rate of 70 cents per kilometre is to continue to apply to both petrol and diesel fuel vehicles

Interpretation statements

IS 10/03: GST: Time of supply – payments of deposits, including to a stakeholder 7

This interpretation statement considers the application of the time of supply rules for GST purposes to the payment of a deposit in various circumstances, including under conditional and unconditional agreements, where a binding agreement does not exist and where payment is made to a stakeholder.

Legal decisions – case notes

High Court finds tax avoidance in an arrangement to develop and sell software 17

The High Court found an arrangement whereby two companies deliberately registered for GST on a mismatched accounting basis and incorporated by non-arm's length individuals for the purpose of developing and selling software was tax avoidance. Consequently, the Commissioner's decision to treat the arrangement as void was correct.

Judicial review: The Commissioner's powers under sections 16 and 16B of the Tax Administration Act 1994 18

The access operation carried out by the Commissioner pursuant to section 16 of the Tax Administration Act 1994 was used to obtain information which was necessary or relevant for the investigation of activities affecting New Zealand tax liabilities.

IN SUMMARY continued

Questions we've been asked

QB 09/06: GST – apportionment of the cost of bare land for the purposes of a change-in-use adjustment 21

This question we've been asked considers the appropriate apportionment method for determining the cost of bare land in situations where a registered person buys land for a taxable purpose and then uses part of that land for private or exempt purposes.

QB 10/04: Shortfall penalty for evasion or a similar act – knowledge required and Interpretation Statement IS0062 26

This question we've been asked relates to the shortfall penalty for evasion in section 141E of the Tax Administration Act 1994. It considers whether section 141E(1)(d)–(f) requires knowledge of the unlawfulness of the act in question. It concludes that for section 141E(1)(d)–(f) to apply, the taxpayer must know that the act in question is unlawful.

Items of interest

Making tax easier – Government consultation June 9 to 23 July 2010 28

A public online consultation forum on changes to the way taxpayers deal with Inland Revenue has been launched.

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.

DETERMINATION FDR 2010/02: USE OF FAIR DIVIDEND RATE METHOD FOR A TYPE OF ATTRIBUTING INTEREST IN A FOREIGN INVESTMENT FUND

Reference

This determination is made under section 91AAO(1)(a) of the Tax Administration Act 1994. This power has been delegated by the Commissioner of Inland Revenue to the position of Investigations Manager under section 7 of the Tax Administration Act 1994.

Discussion (which does not form part of the determination)

Units in a non-resident issuer to which this determination applies are an attributing interest in a foreign investment fund (FIF) for New Zealand resident investors. New Zealand resident investors are required to apply the FIF rules to determine their tax liability in respect of their units in the non-resident issuer each year.

As the non-resident issuer invests solely in financial arrangements denominated in New Zealand dollars, section EX 46(10)(c) of the Act applies. In addition, the non-resident issuer may provide investors the ability to protect capital by locking in a minimum return equal to a proportion of the net asset value or index level achieved by the issuer in relation to the financial arrangements which may mean that section EX 46(10)(d) of the Act applies. Accordingly, New Zealand resident investors are prevented from using the fair dividend rate method in the absence of a determination under section 91 AAO of the Tax Administration Act 1994.

Despite the non-resident issuer having assets which 80% or more by value consist of financial arrangements denominated in New Zealand dollars and the ability of the funds to lock in a proportion of the net asset value or index level achieved, the Commissioner considers that it is appropriate for New Zealand resident investors in this arrangement to use the fair dividend rate method. The overall arrangement (as described by the applicant) contains sufficient risk so that it is not akin to a New Zealand dollar-denominated debt instrument or one that effectively provides guaranteed returns.

Scope of determination

The investments to which this determination applies are units in a non-resident issuer which:

a) is a unit trust that is established and tax resident in Australia;

b) is managed by Liontamer Investment Management Pty Limited (Liontamer), a company incorporated and tax resident in Australia, or an entity which is associated with Liontamer;

c) issues New Zealand denominated units (not being fixed rate shares or non-participating redeemable shares) to New Zealand resident investors;

d) invests proceeds from the issue of units in assets which are financial arrangements, in relation to which the value is calculated by reference to either:

   i) the movement in the value of an underlying basket of:

      - shares in companies listed on a recognised exchange;
      - commodities;
      - real property;
      - non-NZD denominated fixed interest securities traded on a recognised market

   ii) the movement in an index or selected indices relating to the value of items listed in (i) above;

   iii) the movement in the value of an underlying actively managed fund or basket of funds investing in items listed in (i) above;

   iv) the movement in currencies traded on a recognised market;

   v) any combination of (i) to (iv);

e) if it invests in financial arrangements in relation to which the return is determined by reference in any way to underlying non-New Zealand dollar denominated fixed interest securities, does not invest in any currency arrangements which provide an overall economic return as if the securities were denominated in New Zealand dollars;

f) does not derive a fixed return in excess of 1.00% per annum;

g) may make distributions to the unit holders, but investors are not guaranteed that any income will be derived or that a distribution will be made;

h) may pay to an investor an amount exceeding the issue price of the unit on redemption, but at the time the unit is first issued does not guarantee the redemption price of a unit will exceed its issue price;

i) may enter into investments where the value is set by reference to a proportion of the net asset value or index level at specified times or over specified periods which could produce a minimum value in excess of the issue price of the units, but at the time units are first issued does not guarantee a return in excess of the issue price.

Interpretation

In this determination, unless the context otherwise requires—

"Associated" means associated persons under sections YB 1 to 21 of the Act;

"Financial arrangement" means financial arrangement under section EW 3 of the Act;

"Fixed rate share" means a fixed rate share under section LL 9 of the Act;

"Non-participating redeemable share" means a non-participating redeemable share under section CD 22(9) of the Act;

"Non-resident" means a person that is not resident in New Zealand for the purposes of the Act;

"Recognised exchange" means recognised exchange under section YA 1 of the Act;

"Recognised market" means a recognised exchange under section YA 1 of the Act, reading paragraphs (c) and (d) of the definition of recognised exchange to include currencies or financial arrangements;

"The Act" means the Income Tax Act 2007.

Determination

An attributing interest in a FIF to which this determination applies is a type of attributing interest for which a person may use the fair dividend rate method to calculate FIF income from the interest.

Revocation

Determination FDR 2010/02 replaces determination FDR 2008/01. Determination FDR 2008/01 is revoked from the 2010–11 income year.

Application date

This determination applies for the 2010–11 and subsequent income years.

Dated at Christchurch this 28th day of May 2010.

John Trezise
Investigations Manager

CATEGORIES OF TAXPAYERS WHO NEED TO REQUEST A PERSONAL TAX SUMMARY

Background

The Taxation (Consequential Rate Alignment and Remedial Matters Act) 2009 amended section 33A(5) of the Tax Administration Act 1994, allowing Inland Revenue discretion in selecting who should be issued personal tax summaries (PTSs).

What this means

The amendment means that Inland Revenue may not automatically issue PTSs to groups of customers who previously received them, particularly when it's likely the correct amount of tax has been withheld during the year.

This change will reduce compliance and administration costs to both Inland Revenue and taxpayers.

Taxpayers will still be able to request a PTS from Inland Revenue by following the existing processes.

There have been no changes to the legislation regarding the circumstances when a taxpayer must file an IR 3 tax return.

Customers who must request a PTS

Customers who are not required to file an IR 3 tax return will need to request a PTS in the following circumstances.

If you **haven't** automatically received a PTS by the customer's terminal tax date **you must** request one if you:

- received income that has not had sufficient PAYE deducted and the residual income tax (RIT) is $500 debit or credit
- received income with PAYE deducted that has not had sufficient student loan deductions made and the residual repayment obligation is more than $20
- received more than $200 of secondary employment earnings and these earnings were not taxed at:
  - 33% and your income was more than $48,000 but not more than $70,000, or
  - 38% or 39% and your income was more than $70,000
- received more than $200 as an election day worker and you used the EDW tax code
- received more than $200 as a casual agricultural employee and you used the CAE tax code
- received income that has tax deducted at a rate determined by a special tax code
- received Working for Families Tax Credits (WfFTC) from Inland Revenue during the tax year or are registered for WfFTC and entitled to receive a lump sum payment
- are or were married or in a civil union or de facto relationship during the tax year with a person who received WfFTC from Inland Revenue or who is registered for WfFTC and is entitled to receive a lump sum payment for that tax year
- received WfFTC from Work and Income during the tax year and the amount of family credit abatement under section MD 13 of the Income Tax Act 2007 is greater than zero
- are married or in a civil union or de facto relationship during the tax year with a person who received WfFTC from Work and Income during the tax year and the amount of family credit abatement under section MD 13 of the Income Tax Act 2007 is greater than zero during that tax year.

Inland Revenue will not automatically issue a PTS but **you must** request one if you:

- received more than $200 of interest and/or dividends, not including amounts that did not require an RWT certificate under section 25(7) of the Tax Administration Act 1994, and the interest and/or dividends were not taxed at:
  - 33% and your income was more than $48,000 but not more than $70,000, or
  - 38% or 39% and your income was more than $70,000
- received more than $200 of extra emoluments and these were not taxed at:
  - 33% and your income was more than $48,000 but not more than $70,000, or
  - 38% or 39% and your income was more than $70,000
- received more than $200 of dividends and your income was more than $70,000
- received more than $200 of Māori Authority distributions and your income was more than $48,000
- received more than $200 of interest, dividends or Māori Authority distributions and you were required to pay financial support under the Child Support Act 1991
- received more than $200 of interest, dividends or Māori Authority distributions and:
  - you have a student loan as defined in section 2 of the Student Loan Scheme Act, and
  - that balance is not nil on 31/03/2010, and
  - your income is more than $19,084.

OPERATIONAL STATEMENTS

2010 REVIEW OF THE COMMISSIONER'S MILEAGE RATE FOR EXPENDITURE INCURRED FOR THE BUSINESS USE OF A MOTOR VEHICLE

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

Inland Revenue has reviewed the motor vehicle mileage rate reflecting on the average cost of running a motor vehicle, including the average petrol and diesel fuel prices for the 2010 income year, and confirms the current mileage rate of 70 cents per kilometre is to continue to apply to both petrol and diesel fuel vehicles.

Inland Revenue will continue to monitor fuel prices and publish a rate at least once a year.

Taxpayers are not obliged to use the Commissioner's mileage rate. They may use actual costs if they consider that the Commissioner's mileage rate does not reflect their true costs.

It is accepted that employers may use the motor vehicle running cost data published by other reputable sources, for example the New Zealand Automobile Association Incorporated, as an alternative reasonable estimate for reimbursement of employees.

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

INTERPRETATION STATEMENT

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

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

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

IS 10/03: GST: TIME OF SUPPLY – PAYMENTS OF DEPOSITS, INCLUDING TO A STAKEHOLDER

This interpretation statement considers certain aspects of the time of supply rule in section 9(1) of the Goods and Services Tax Act 1985, particularly in regard to situations involving the payment of a deposit. The conclusions reached are summarised below.

The Commissioner previously published a policy statement "GST: General time of supply rules – receipt of deposits" in *Tax Information Bulletin*, Vol 6, No 7, (December 1994). As from 27 May 2010 this interpretation statement withdraws and replaces that earlier statement.

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

Summary

1. Section 9(1) provides that a supply is deemed to take place at the earlier of:
   - the time an invoice is issued by the supplier or the recipient in respect of that supply; or
   - the time any payment is received by the supplier in respect of that supply.

   Note that this statement deals only with the time of supply where payment is received and does not consider the issue of an invoice. In any particular situation, the issue of an invoice could cause the time of supply to be triggered.
2. Before section 9(1) will apply, it is necessary to establish there is a transaction giving rise to a supply that is chargeable with GST. Section 9(1) is a timing-only provision, and it will only apply to fix the time of supply if there is a transaction giving rise to a supply. In determining whether a transaction giving rise to a supply exists, the legal arrangements entered into between the parties must be considered. Where there is a binding contract, such a transaction is assumed. Where there is no contract, the existence of a transaction giving rise to a supply will be established where there are reciprocal obligations between the parties.
3. A deposit constitutes "any payment". Where a supplier receives a deposit under a contract, the time of supply will be triggered under section 9(1). This applies equally to conditional or unconditional contracts.
4. Where a deposit is paid to a person as stakeholder, there will have been no receipt by the supplier and the time of supply will not be triggered. A supplier may be a stakeholder.
5. A stakeholder relationship requires agreement by all parties. A person cannot declare himself or herself a stakeholder unilaterally. A stakeholder holds the deposit on behalf of both parties and owes a contractual or quasi-contractual obligation to both parties. The intention of the parties, determined from all the circumstances, will establish in which capacity a person receives a deposit.
6. Where there is no binding contract, it must be shown that the payment is for the supply of goods or services, whether the physical supply takes place now or in the future. Where this is the case, the receipt of the payment by the supplier will trigger the time of supply.

Background

7. In the Commissioner's previously published statement, referred to above, the Commissioner considered that the supplier of goods and services could not act as a stakeholder. A stakeholder had to be an independent third party.
8. Since the publication of that statement, the High Court released its decision in *CIR v Dormer* (1997) 18 NZTC 13,446. That decision provides authority for a supplier to be a stakeholder.
9. The Commissioner has decided to review the application of the time of supply rules in section 9(1) to the receipt of deposits and to provide some guidance on the requirements for a person to be acting as stakeholder.

Legislation: Goods and Services Tax Act 1985

10. "Consideration" is defined in section 2(1) as:

    Consideration, in relation to the supply of goods and services to any person, includes any payment made or any act or forbearance, whether or not voluntary, in respect of, in response to, or for the inducement of, the supply of any goods and services, whether by that person or by any other person; but does not include any payment made by any person as an unconditional gift to any non-profit body:

11. Section 5(1) provides:

    For the purposes of this Act, the term "**supply**" includes all forms of supply.

12. Section 6(1)(a) provides:

    For the purposes of this Act, the term **taxable activity** means—

    (a) Any activity which is carried on continuously or regularly by any person, whether or not for a pecuniary profit, and involves or is intended to involve, in whole or in part, the supply of goods and services to any other person for a consideration; and includes any such activity carried on in the form of a business, trade, manufacture, profession, vocation, association, or club:

13. Section 8(1) provides:

    Subject to this Act, a tax, to be known as goods and services tax, shall be charged in accordance with the provisions of this Act at the rate of 12.5 percent on the supply (but not including an exempt supply) in New Zealand of goods and services, on or after the 1st day of October 1986, by a registered person in the course or furtherance of a taxable activity carried on by that person, by reference to the value of that supply.

14. Section 9(1) provides:

    Subject to this Act, for the purposes of this Act a supply of goods and services shall be deemed to take place at the earlier of the time an invoice is issued by the supplier or the recipient or the time any payment is received by the supplier, in respect of that supply.

Analysis

Section 9(1)

15. The general rule for determining the time of supply is set out in section 9(1), which provides:

    Subject to this Act, for the purposes of this Act a supply of goods and services shall be deemed to take place at the earlier of the time an invoice is issued by the supplier or the recipient or the time any payment is received by the supplier, in respect of that supply.

16. Therefore, under section 9(1) a supply is deemed to take place at the earlier of:

    - the time an invoice is issued by the supplier or the recipient in respect of that supply; or
    - the time any payment is received by the supplier in respect of that supply.

17. Before section 9(1) will apply, it is necessary to establish there is a transaction giving rise to a supply that is chargeable with GST. In determining whether such a transaction exists, the legal arrangements entered into between the parties must be considered. See *CIR v Databank Systems Ltd* (1989) 11 NZTC 6,093 (CA), (1990) 12 NZTC 7,228 (PC); *Wilson & Horton Ltd v CIR* (1995) 17 NZTC 12,325; *Pine v CIR* (1998) 18 NZTC 13,570; *Chatham Islands Enterprise Trust v CIR* (1999) 19 NZTC 15,075; *CIR v Capital Enterprises Ltd* (2002) 20 NZTC 17,511.

18. Section 9(1) is a timing-only provision and will only apply to fix a time of supply if there is a transaction giving rise to a supply. If there is no supply (whether it is performed now or in the future), then section 9(1) cannot operate.

19. Durie J, in *CIR v Capital Enterprises Ltd*, said (at p 17,519):

    [49] Section 9 does no more than fix a time of supply for the purposes of the Act, as the section says. The purpose of the Act is to tax the supply of goods and services in the course of trade. In furtherance of that purpose s 9 appears to be no more than a mechanical provision to assist the imposition and collection of that tax by determining such matters as when tax becomes payable or deductible (see *Richardson P in Pine v C of IR* (1998) 18 NZTC 13,570 (CA) at p 13,573).

20. This statement considers the application of section 9(1) to the payment of deposits. For the purposes of the following discussion, it is assumed that an invoice has not been issued prior to the receipt of any payment.

21. The application of section 9(1) is discussed below in relation to the payment of a deposit in the following different circumstances:

    - A payment made under an unconditional contract
    - A payment made under a conditional contract
    - A payment made when no contract exists.

A payment made under an unconditional contract

22. The discussion in this part of the statement deals with the most common scenario; that is, deposits paid under contracts where agreement has been reached between the parties on all terms and only performance of the contract remains to be concluded. In other words, there are no conditions or other matters that could affect a contract's execution. Note that the position of payments made under agreements subject to conditions (that is, conditional contracts), is dealt with later in this statement.

23. The Commissioner's view is that where a deposit is paid under an unconditional contract the position is straightforward. There is a supply and the deposit is paid in respect of that supply. Section 9(1) will deem the time of supply to be when the deposit is received by the supplier. This will be so even if the goods or services have not been physically supplied or performed at that time. This view is supported by the cases discussed below.
24. In *Case L67* (1989) 11 NZTC 1,391, the issue was whether a subdivider of land had to pay GST on the full sale price of sections of land at the time of selling them at auction or at the later time when the subdivider could provide title to the purchaser and complete settlement. Barber DJ concluded that GST on the full sale price had to be paid on the day of the auction and signing of the contract and payment of the deposit. Section 9(1) deemed the supply to have taken place on that day. There was a binding contract from the outset and only performance of the contract, or final implementation, was delayed until title was available.
25. In *Case N24* (1993) 13 NZTC 3,196, the taxpayer had entered into an agreement to sell a property. The agreement became unconditional on 18 August 1987 and the deposit was paid in two instalments on 19 August and 5 November 1987. The taxpayer did not return GST on the sale, claiming that because of the share market crash and the failure of the purchaser to obtain public subscriptions it was unlikely the purchaser would be able to complete the purchase. The purchaser did fail to complete on settlement date (28 February 1988) and the contract was cancelled on 22 August 1988. The taxpayer retained the deposit as damages for breach of contract.
26. Barber DJ confirmed his reasoning in *Case L67* and, although the question before him was only whether the taxpayer should have returned GST on the amount of the deposit, he noted that the taxpayer should have returned GST on the full value of the supply that took place on 19 August 1987 when the first deposit was paid. The taxpayer was deemed by section 9(1) to have made the supply on that date. The fact that the contract was later cancelled and the supply of the property did not take place, did not avoid the GST liability on the deemed supply of 19 August 1987.
27. In *Auckland Institute of Studies Ltd v CIR* (2002) 20 NZTC 17,685, tuition fees were paid to the supplier under a contract. The supplier was entitled to a small portion of the fees immediately and the balance had to be held in trust until after the student had attended a course for more than seven days. Hansen J applied *Case L67* and *Case N24* and held that the receipt of the first amount by the supplier triggered the time of supply for the full value of the supply. The supplier had received a payment in respect of the supply of the services and section 9(1) applied.

Another view

28. Another view is that the payment of a deposit under an agreement will not comprise "payment" that triggers the time of supply until completion and payment of the full amount under the agreement. This view focuses on the purpose of a deposit and claims that until completion a deposit is simply a surety.
29. General case law establishes that a deposit serves two purposes. A deposit is part payment of the purchase price and it is a guarantee that the purchaser means business: *Howe v Smith* (1884) 27 ChD 89; *Soper v Arnold* (1889) 14 App Cas 429 [note that if difficulties are experienced in accessing copies of these two cases, copies are available from the Office of the Chief Tax Counsel on request]; *Martin v Finch* [1923] NZLR 570. The view is that a deposit's primary purpose is as a guarantee or surety on the purchaser's behalf and that it does not become part payment of the purchase price until the agreement has been completed.
30. However, the Commissioner considers the better view is that a deposit does constitute "any payment" within the words of section 9(1). Although the New Zealand judiciary has not addressed this issue directly, there is significant authority confirming that a deposit constitutes "any payment": for example, *Case L67*; *Case N24*; *Auckland Institute of Studies Ltd v CIR*; *Barratt v CIR* (1995) 17 NZTC 12,372, 12,377; *CIR v Dormer* (1997) 18 NZTC 13,446, 13,458; *Rob Mitchell Builder Ltd (in liq) v National Bank of New Zealand Ltd* (2004) 21 NZTC 18,397, para 4.
31. Some commentators claim that support for the alternative view can be found in the High Court of Australia decision in *FCT v Reliance Carpet Co Pty Ltd* [2008] HCA 22. However, the Australian decision has little persuasive value in this context because of the significant differences in the relevant legislation. The High Court of Australia noted the distinction itself when it commented that no assistance was to be derived by that court from a consideration of the treatment of deposits in the New Zealand taxation system.
32. On the other hand, the United Kingdom VAT cases provide strong support for the view that a deposit is part payment of the purchase price in this context and constitutes a payment received in respect of the supply.

See, for example, *MH Caine* (1987) 3 BVC 1,325; *Bethway & Moss Ltd* (1988) 3 BVC 718; *Regalstar Enterprises* (1988) 3 BVC 866; *Bruce Banks Sails Ltd* (1990) 5 BVC 1,357; *Bristol Bathroom Co Ltd v C&E Commrs* [1991] 3 C.M.L.R. 947; *C&E Commissioners v Moonrakers Guest House Ltd* [1992] BTC 5,077; *Simplelink Ltd t/a Homecare Exteriors* [1995] BVC 1,372; *Kirtley t/a Encore International* [1995] BVC 1,520; *Hollybourne Hotels Ltd* [2002] BVC 4,030. The United Kingdom Revenue has also adopted this approach: See HM Revenue & Customs notice, VATTOS5120 – Actual tax points: Payments: Deposits and pre-payments.

33. The Commissioner considers the better view is that the receipt of a deposit by the supplier under an unconditional agreement is the receipt of "any payment" and will trigger the time of supply under section 9(1).

Deposit – payment for different supply

34. As stated above, the legal arrangements between the parties must be analysed in order to identify the supply. There may be situations where, on a careful consideration of the facts, it is determined there is more than one supply taking place, that is, there is a supply that occurs before the main supply ("a preliminary supply"). This might occur, for example, in the case of a wedding function where a preliminary supply relating to the securing of a particular date takes place before the main supply of the actual function. However, it is considered that this situation would be unusual. In *Kirtley t/a Encore International* it was held that deposits paid to book a function were in the nature of part payments of the full amount due under the contract and triggered the tax point (time of supply). A similar decision was reached in *Hollybourne Hotels Ltd* in relation to deposits received by hotels for wedding receptions and functions.

35. It is clear from decisions such as *Auckland Institute of Studies Ltd v CIR*, *Case L67* and *Case N24* that a supply cannot simply be divided into several parts. The question of whether a payment is made for a preliminary supply, separate from the main supply, will always depend on the facts in each particular case and a determination of the true legal arrangements entered into by the parties.

A payment made under a conditional contract

36. This part of the statement deals with the receipt of a deposit by a supplier under a conditional contract.

Meaning of "conditional contract"

37. A useful summary of the current state of New Zealand law in relation to conditional contracts is in *Laws NZ*, Contract para 154:

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

38. Criticism of the terms "condition precedent" and "condition subsequent" occurred in the judgment of Cooke J (as he then was) in the Court of Appeal decision in *Hunt v Wilson* [1978] 2 NZLR 261 at p 267. His Honour then reiterated this sentiment in *Robertson Enterprises Ltd v Cope* [1989] 3 NZLR 391 at p 393.

39. These authorities suggest that the more appropriate method of analysis is to focus on the nature of the condition to determine whether the condition prevents the formation of a binding contract or whether the condition suspends some right or obligation until the condition is satisfied.

40. A conditional offer or conditional acceptance would not result in a binding contract: *Reporoa Stores Ltd v Treloar* [1958] NZLR 177; *Buhrer v Tweedie* [1973] 1 NZLR 517; *Frampton v McCully* [1976] 1 NZLR 270.

Agreements that are "subject to contract" or "subject to the drawing up of a formal contract" are not binding contracts if it can be inferred that the parties did not intend to be bound until the formal agreement had been signed: *Carruthers v Whitaker* [1975] 2 NZLR 667. There is a difference between that kind of condition and a condition that suspends some right or obligation under an already binding contract until the condition is satisfied. If a condition of the latter kind is not satisfied, the contract is or may be terminated, but in the meantime there is a binding agreement: *Provost Developments Ltd v Collingwood Towers Ltd* [1980] 2 NZLR 205; *Connor v Pukerau Store Ltd* [1981] NZLR 384.

41. The key distinction is between conditions that must be satisfied before there will be a binding contract and conditions that suspend some right or obligation under an already existing binding contract until the condition is satisfied. For the purposes of this statement, any reference to a conditional agreement is to an agreement subject to the latter type of condition. In other words, a conditional agreement is an existing binding agreement that is subject to conditions.

Receipt of payment by supplier under conditional contract

42. In most circumstances, the position under a conditional contract is the same as under an unconditional contract. As a binding contract exists, there is a supply and any payment made is in respect of that supply. A deposit received by the supplier will trigger the time of supply under section 9(1).

43. Very few New Zealand cases have dealt with the issue of the time of supply in relation to the payment of a deposit under a conditional contract. Those that do provide some support for the conclusion that receipt of a deposit by a supplier under a conditional contract will trigger the time of supply. However, the decisions all deal with payment of the deposit to a stakeholder, rather than to the supplier directly. This reflects the fact that, in practice, it would not be common for a purchaser to pay a deposit directly to a supplier when a contract is still conditional.

Receipt of payment by a stakeholder

44. In many cases a deposit will be paid to a person to hold it as stakeholder until an agreement becomes unconditional. This situation is most common in relation to the supply of land. Where a deposit is paid to a stakeholder, the supplier will not have received any payment and the time of supply will not have been triggered.

45. The only New Zealand case to consider the issue of a stakeholder in a GST context in any depth is *CIR v Dormer* (1997) 18 NZTC 13,446. The case involved a husband and wife farming partnership, registered for GST, which sold some land. The Commissioner assessed the partnership for GST on the sale. The TRA found for the taxpayers, holding that as the land was owned by the husband, who was not registered for GST, no GST was payable on the sale. In case it was later held that the partnership had made the supply, the TRA also found that the time of supply was the date the deposit was paid by the purchaser to the vendor's agent.

46. On appeal, the High Court agreed with the TRA that no GST was payable on the sale of the property because the partnership did not own the land. However, Salmon J also went on to consider the TRA's finding in relation to the time of supply.

47. Salmon J held that a deposit is not received by a supplier as long as any person holds it as stakeholder, whether that person is the supplier or an independent third party. A deposit will not be received unless the supplier, or the supplier's agent, receives it for his or her own benefit, or, in the case of a deposit paid to an agent, for the principal's benefit. His Honour concluded that the obligation to hold the deposit as stakeholder means the deposit is not received for the supplier's benefit, even if the stakeholder is the supplier. As a payment must be received by the supplier in order for the time of supply to be triggered, receipt by a stakeholder will not trigger the time of supply. The circumstances of each case will determine in which capacity a person holds funds.

48. In *Auckland Institute of Studies Ltd v CIR* (2002) 20 NZTC 17,685 (at p 17,699) Hansen J agreed with the analysis and conclusion in *CIR v Dormer* that there could be no receipt of a payment by the supplier for the purposes of section 9 when the recipient of the payment was obliged to hold the funds as stakeholder. His Honour stated that a deposit is not received until the supplier or his agent receives it for his own benefit.

49. The position of a stakeholder in a GST context was also mentioned briefly in *CIR v Bhanabhai* (2005) 22 NZTC 19,533 at p 19,357. In a discussion on the requirements of a vendor to account for GST as soon as a purchaser has made the first payment, Laurenson J noted that the one exception was if the deposit was held by a stakeholder. In *Ch'elle Properties (NZ) Ltd v CIR* (2004) 21 NZTC 18,618 at p 18,621, Rodney Hansen J also noted that payment included payment of a deposit unless held by the recipient as stakeholder.

50. Thus, the decision in *Dormer* established that the receipt of a payment by a stakeholder means the supplier has not received payment within the provisions of section 9(1). This is the case whether the stakeholder is the supplier or an independent third party. In order for a supplier to "receive" payment within the terms of section 9(1), the supplier must have received the payment for his or her own benefit. An obligation to hold as stakeholder means a supplier has not received payment for his or her own benefit and this will prevent receipt.
51. In some cases a deposit paid may be stated to be non-refundable. If the facts show that the supplier is entitled to the deposit from the moment of payment, then the supplier will have received payment and the time of supply will have been triggered. However, if the deposit is paid to a stakeholder and the facts show that the deposit cannot be applied to the supplier's benefit until the happening of a specific event, such as on the cancellation of the contract, then the stakeholder rules will apply. The time of supply will not be triggered until that particular event occurs and the stakeholder obligations are therefore at an end. At that time the supplier will have received the payment for his or her own benefit and time of supply will have occurred.
52. Stakeholder obligations most commonly end at the time the contract becomes unconditional. However, the specific event which ends a stakeholding relationship is determined by the terms of the particular stakeholding agreement. For example, in circumstances where the solvency of a supplier is in question, the purchaser may negotiate to ensure the stakeholding relationship continues beyond the unconditional date to the date of settlement. Where the stakeholding obligations continue and the supplier has not received any payment for his or her own benefit (and providing an invoice has not been issued), the time of supply will not have occurred and the supplier will not have to account for GST. Note that a purchaser in this situation would also be unable to claim an input tax credit until the time of supply was triggered.
53. In some cases a third party stakeholder may also be the agent of the supplier, for example, a real estate agent or solicitor. If the third party receives the payment in its capacity as stakeholder, then it will not have received the money in its capacity as the supplier's agent and the supplier will not have received payment. The only exception to this will be if the third party stakeholder pays or applies the payment to the supplier or for the supplier's benefit during the period of the stakeholding in error. This may occur, for example, where the stakeholder mistakenly believes the relevant event has taken place (such as the contract becoming unconditional) or the stakeholder accedes to a unilateral request by the supplier. As the supplier is not acting in any stakeholder capacity, the supplier will have received payment for the purposes of section 9(1).
54. As discussed below, a stakeholder relationship requires agreement between all the parties. If a third party stakeholder mistakenly makes payment to the supplier, the supplier cannot unilaterally impose stakeholder obligations on himself or herself. Therefore, nothing prevents the supplier from having received the payment. This is consistent with the fact that if a stakeholder pays the deposit to the supplier in breach of its stakeholding obligations, the recourse for the purchaser is with the stakeholder: see, for example, *Hastingwood Property Ltd v Saunders Bearman Anselm* [1991] Ch 114.
55. The next part of this statement considers what is required to show that a person is holding a payment as stakeholder.

Requirements of a stakeholder

56. The cases show the essential requirement for a stakeholder relationship is the existence of an agreement between the parties. A person cannot establish himself or herself as a stakeholder unilaterally.
57. A stakeholder's obligations are determined by agreement between the parties and the stakeholder. Under that agreement, a stakeholder is required to hold the funds until a defined event takes place. That event establishes who is entitled to the money. The parties have no proprietary interest in the funds until that event takes place.
58. A person who holds money as a stakeholder does not act as agent for either party. A stakeholder, in their capacity as stakeholder, holds the funds for both parties and owes a contractual or quasi-contractual obligation to both parties. This is the case even if the person acting in the capacity of stakeholder is also acting in the capacity of agent for one or other of the parties.
59. The cases establish that, in ordinary circumstances, a stakeholder (unless he or she is a real estate agent or solicitor) is entitled to retain any interest earned on the funds while they are in his or her possession. Equally, a stakeholder is liable for any loss suffered. Note that in practice, however, the entitlement to interest may be dealt with as a term of the stakeholding agreement between the parties and who is entitled to the interest on the deposit may therefore vary. For example, entitlement to the interest may be determined in favour of the supplier if settlement proceeds and in favour of the purchaser if it does not,

or it may be applied to the purchase price on behalf of the purchaser. In general this will not occur until settlement. Note that if the supplier as stakeholder is entitled to the interest and the interest is applied to the purchase price, the interest will constitute a payment *received by the supplier in respect of the supply* and the time of supply will be triggered.

60. The consent of both parties is necessary to vary a stakeholder's obligations.

61. The intention of the parties, determined from all the circumstances, will establish in which capacity a person receives the money.

62. The existence of a separate bank account in which the funds are placed (although not a legal requirement) combined with clear written confirmation of the stakeholder relationship will generally support the contention that a person is a stakeholder.

63. See, for example, *Potters (a firm) v Loppert* [1973] 1 All ER 658; *Neate v Manchester Home Centre Ltd* 22 April 1989, Tipping J, HC Christchurch CP343/89; *Vahora v Tse* (1999) 4 NZ ConvC 192,923; *Rockeagle Ltd v Alsop Wilkinson (a firm)* [1991] 4 All ER 659; Treitel, *The Law of Contract*, 11th ed, Sweet & Maxwell, London, 2003, at p 526; *Bowstead and Reynolds on Agency*, 17th ed, Sweet & Maxwell, London, 2001, at para 9-026; and McMorland, *Sale of Land*, 2nd ed, Cathcart Trust, Auckland, 2000, para 7.05.

A payment made when no contract exists

64. The discussion in this part of the statement considers the situation where a payment has been made but there is no binding contract.

65. As stated earlier in this statement, the legal arrangements between the parties must be considered in determining whether a supply exists. Where a binding contract exists and a payment is made pursuant to that contract, there is an automatic assumption that a supply exists. However, a supply need not necessarily be made under a contract. The crucial question is not whether there is a contract, but whether there is a supply.

66. In the absence of a binding contract there is no automatic assumption of a transaction giving rise to a supply. It is necessary, therefore, to consider whether there has in fact been a supply that is chargeable with GST. Has the payment received been made **for** a supply?

Consideration

67. Where a payment is made, it is necessary to establish a link between the payment and a supply, that is, that the payment constitutes "consideration" for a supply. To satisfy the definition of "consideration", the payment must be made in respect of, in response to, or for the inducement of that supply. The mere receipt of payment will not necessarily indicate the existence of a taxable supply. Not all payments received by a registered person in the course of their taxable activity will be for supplies. If there is no supply, the payment cannot be consideration. See, for example, *Chatham Islands Enterprise Trust v CIR* (1999) 19 NZTC 15,075; *CIR v NZ Refining Co* (1997) 18 NZTC 13,187.

68. While it is necessary for there to have been a supply of something, the supply need not be made to the person who makes the payment: T*urakina Maori Girls College Board of Trustees v CIR* (1993) 15 NZTC 10,032 at p 10,036.

69. There is a practical necessity for a sufficient connection between the payment and the supply, but a strict contractual analysis does not need to be undertaken in order to link a payment to a supply. See *NZ Refining Co Ltd* at p 13,193; *Turakina* at p 10,036.

70. The GST definition of consideration has been interpreted in the High Court as wider than the common law meaning: *The Trustee, Executors and Agency Co NZ Ltd v CIR* (1997) 18 NZTC 13,076, at p 13,085. However, it has also been made clear that while the statutory definition of consideration in the GST Act is wider than the contract law meaning, the definition does not remove the contract law requirement for an element of reciprocity to be present within a transaction in order for the payment to be "consideration" for a supply: *Taupo Ika Nui Body Corporate v CIR* (1997) 18 NZTC 13,147 at p 13,150.

71. The focus of the GST legislation, therefore, is on establishing a nexus between the supply and payment. As Blanchard J said in *NZ Refining Co Ltd* (at p 13,193), "to constitute consideration for a supply the payment must be **for** that supply" (emphasis added).

Reciprocal obligations

72. The cases emphasise the necessity for reciprocal obligations between the parties. If a supply cannot be connected to the payment by reciprocal obligations, it cannot be said the payment is consideration for the supply. There must be reciprocal obligations between the parties to make payment and to make a supply of goods or services for the payment. A payment made merely in the hope that a supply would be made is not sufficient to constitute consideration. See *NZ Refining Co Ltd*; *Taupo Ika Nui Body Corporate*; *Chatham Islands Enterprise Trust*; *CIR v Suzuki* (2000) 19 NZTC 15,819.

73. The Commissioner considers that the requirement for reciprocal obligations will generally be satisfied if it can be shown that payment has been made by one party **for** the supply of goods or services by another party, whether performance of the supply takes place concurrently or in the future. Where this is the case, there will be a transaction giving rise to a supply and the receipt of the payment by the supplier will trigger the time of supply in relation to that supply.
74. An example of a payment made where there were no reciprocal obligations can be seen in the UK VAT decision in *Nigel Mansell Sports Co Ltd* [1991] BVC 718. In that case the taxpayer held a franchise for Ferrari motorcars. There was a long waiting list for such cars. The taxpayer had taken "deposits" from potential customers who wished to purchase a Ferrari. At the time when the "deposit" was paid, the customer would specify the model, type, colour, etc of the Ferrari that the customer wished to purchase. When a car that corresponded to the customer's requirements became available, the customer might be sent an order form and would then be asked to pay a deposit of 10 percent of the purchase price. That deposit was taken to include the initial sum "deposited". The issue was whether the time of supply arose when the initial payment was made. The tribunal considered that section 5(1) of the Value Added Tax Act 1983 (UK) (the equivalent of section 9(1)) did not have the effect that the tax point (the time of supply) was when the initial payment was made. At that point there was only an agreement to make an agreement, which did not give rise to a supply. The initial payment by the potential customer did not give rise to any rights. Therefore, the tribunal considered that the initial payment did not constitute a payment in respect of any supply.
75. In the unusual circumstances of that case, therefore, it was held that the payment by the potential customer was not for a supply. The payment did not provide the customer with anything. The facts did not evidence any firm commitment on the part of either party to the arrangement—the company was not obliged to offer the potential customer a vehicle, and the customer was under no obligation to purchase a vehicle should one be offered. This was not merely a case of a payment in respect of a supply that might not happen in the future because of particular circumstances (as would be the more common position), but rather it was not a payment in respect of a supply at all.
76. The Commissioner considers this would not be a common situation and, indeed, the United Kingdom HM Revenue & Customs has recognised that *Nigel Mansell* turns on its rather unusual circumstances and in most cases should be distinguishable on its facts: see HM Revenue & Customs notice VATTOS5130 – Actual tax points: payments: Exceptions to normal treatment of deposits and pre-payments.
77. The issue of whether a payment is made "in respect of, in response to, or for the inducement of" a supply is one that must be determined on the facts of each case. There must be a supply made or to be made in order for a payment to constitute consideration.

Examples

Example 1

78. Romeo, a GST-registered person, manufactures iron railings for balconies. On 12 June he enters into an agreement with Juliet to supply an Elizabethan style railing for her balcony. Juliet pays a deposit of 20 percent on the same day. Delivery of the railing is not to take place until 12 August. Payment of the balance of the purchase price is to be made on delivery. Romeo has a 30 June balance date, a two-month taxable period, and accounts on an invoice basis.
79. The time of supply will be triggered on 12 June when Romeo receives payment of the deposit. Therefore, for the purposes of accounting for GST, the supply takes place in the taxable period ending 30 June. Romeo will have to account for the output tax on the full value of the supply by 28 July, even though he will not receive the balance of the purchase price until delivery of the railing.
80. Note that if Romeo accounted on a payments basis, he would only have to account for output tax on the deposit received, not on the full value of the supply, by 28 July. Assuming the balance of the price was paid by Juliet on delivery on 12 August, he would then have to account for the output tax on that amount by 28 September, in relation to the taxable period ended 31 August.

Example 2

81. Othello, a property developer, enters into a conditional agreement to sell a property to Iago. Iago pays a deposit to Desdemona Real Estate Ltd on 25 May 2009. Under the terms of the REINZ–ADLS agreement, the deposit is held by Desdemona Real Estate Ltd as stakeholder and the stakeholding ceases when the agreement becomes unconditional or is cancelled or avoided. The agreement becomes

unconditional on 29 May 2009. Pursuant to section 123 of the Real Estate Agents Act 2008, Desdemona Real Estate Ltd is required to hold the deposit for 10 working days from the date of receipt and as a result it does not pay the deposit to Othello until 8 June. Othello has a standard balance date, a two-month taxable period, and accounts on an invoice basis.

82. The time of supply will be triggered on 29 May 2009 when the agreement becomes unconditional. From that point, Desdemona Real Estate Ltd will be holding the deposit not as stakeholder, but as agent for Othello. In these circumstances, Othello will have received payment for the purposes of section 9(1) and the time of supply will be triggered. Othello will have to account for the output tax on the full value of the supply for the period ending 31 May 2009.

Example 3

83. Hamlet Ltd operates an exclusive hotel, Denmark House. It receives a booking request from Ophelia in April to book three nights' accommodation over Labour Weekend. Hamlet Ltd requires Ophelia to pay one night's accommodation charge as a deposit. If Ophelia cancels more than 48 hours before her booking, she will receive a full refund. If she cancels after that time, she will forfeit her deposit.

84. The time of supply will be triggered on receipt of the deposit by Hamlet Ltd. There is a transaction giving rise to a supply and therefore the receipt of any payment (the deposit) in respect of that supply (the accommodation) will trigger the time of supply under section 9(1). That the deposit may be refundable is irrelevant to the question of whether the time of supply has been triggered. It is also irrelevant that the supply has not actually taken place at the time of the receipt of the deposit.

Example 4

85. Assume the same facts as in Example 3 above, but Hamlet Ltd immediately places the deposit received from Ophelia into a separate account with a third party and claims that the third party is holding the money as stakeholder until the non-refundable period of 48 hours before the start of Ophelia's booking has been reached.

86. The time of supply will still be triggered on receipt of the deposit by Hamlet Ltd. Having received a deposit, a supplier cannot unilaterally decide that the deposit will be held by a third party as a stakeholder. There must be a contractual basis for the stakeholder relationship, i.e. all parties must agree to the stakeholder relationship.

87. Note that if it was agreed by all parties that Ophelia would pay the deposit directly to the third party to hold as stakeholder, then the time of supply would not be triggered. This situation would be similar to that in Example 2 of a deposit paid to a real estate agent to hold as stakeholder.

Example 5

88. Benedict and Beatrice are celebrating their 50th wedding anniversary in three months' time with a function at Dogberry House. An agreement is signed setting out the number of guests, menu, alcohol, and entertainment and specifying the cost to be $5,000. It is acknowledged that details must be finalised no later than one week before the date of the function. Dogberry House requires the couple to make a payment of $500 to confirm the booking. Dogberry accounts for GST on an invoice basis.

89. The amount paid will constitute a deposit in relation to the supply of the function. Therefore, receipt of the $500 from Benedict and Beatrice will trigger the time of supply for Dogberry House and it will have to account for output tax on the $5,000, even though the actual supply will not be made for three months. In the event that changes are later made to any of the details which then necessitate an adjustment to the cost of the function, Dogberry House may make an adjustment to the amount of its previously returned output tax under section 25.

Example 6

90. Portia is getting married in 18 months time. She thinks she would like to hold her wedding function at Shylock Castle. She meets with the functions manager to consider the services the castle can provide, and it is agreed that the wedding will be held at the castle on the date she requests. No arrangements are made as to the nature of the wedding function at this time, with the castle simply agreeing to hold the date for Portia. Portia must confirm the arrangements for her wedding within six months of the chosen date in order to secure the date beyond that time. Portia pays $500 to Shylock Castle to hold the date she wants. The cost of the

wedding will be reduced by this amount if the wedding function goes ahead. The amount paid is refundable at any time up to six months before the wedding.

91. In this situation, it is considered that Shylock Castle has received a payment in respect of a supply of services, being a chose in action, namely Portia's right to hold her wedding at the castle on the date booked. This is a separate supply from that of the function itself. Shylock Castle will have to account for output tax on the $500 only at this time.

92. This can be contrasted with the situation in the Nigel Mansell case discussed in the body of this statement. In the unusual circumstances of that case, the finding of fact was that the payment did not secure anything for the customer. In contrast, Portia has secured the date for her function.

LEGAL DECISIONS – CASE NOTES

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

We've given full references to each case, including the citation details where it has already been reported. Details of the relevant Act and section will help you to quickly identify the legislation at issue. Short case summaries and keywords deliver the bare essentials for busy readers. The notes also outline the principal facts and grounds for the decision.

These case reviews do not set out Inland Revenue policy, nor do they represent our attitude to the decision. These are purely brief factual reviews of decisions for the general interest of our readers.

HIGH COURT FINDS TAX AVOIDANCE IN AN ARRANGEMENT TO DEVELOP AND SELL SOFTWARE

Case	Education Administration Limited v The Commissioner of Inland Revenue
Decision date	5 May 2010
Act(s)	Goods and Services Tax Act 1985
Keywords	Tax avoidance, GST, software development, registration, invoice basis, payments basis

Summary

The High Court found an arrangement whereby two companies deliberately registered for GST on a mismatched accounting basis and incorporated by non-arm's length individuals for the purpose of developing and selling software was tax avoidance. Consequently, the Commissioner's decision to treat the arrangement as void was correct.

Impact of decision

The decision confirms that artificial and contrived arrangements involving mismatches in goods and services tax (GST) accounting and payments bases will be struck down by the Court as tax avoidance arrangements.

Facts

In 2001, Mr Grove was managing two Kip McGrath Education Centres ("the Centres") owned by his mother. He entered into an agreement with his mother's accountant Mr Grimmett to develop a software program for recording financial information that could be tailored to the Centres' needs. Two separate companies, the Taxpayer owned by Mr Grove's trust and Administration Systems Development Limited ("ASDL") owned by Mr Grimmett were established.

ASDL was responsible for developing the software and the Taxpayer was responsible for marketing and selling it once it was developed.

The Taxpayer was registered for goods and services tax (GST) on the invoice basis (filing its returns each month) and ASDL was registered for GST on the payments basis (filing its returns every six months). It was acknowledged that the registrations had been done this way deliberately as a means of generating funding for the development of the software.

The Commissioner assessed the Taxpayer by disallowing its tax input credits on the grounds of tax avoidance.

Decision

Her honour Justice French found that the arrangement had tax avoidance as a more than merely incidental purpose or effect and was structured in a way that could not have been contemplated by Parliament. The arrangement was found to be artificial and contrived in the manner described in *Ben Nevis Forestry Ventures Limited & Ors v CIR* [2009] 2 NZLR 289 (SC). In coming to this decision Justice French considered the following factors to be significant.

The relationship between the parties

It was considered that the creation of the two companies was pivotal to obtaining a GST benefit. Also the relationship and dealings between Mr Grove and Mr Grimmett were not at arm's length and were considered to be more in the nature of a joint venture rather than separate businesses. The Court could see no reason why the different objectives could not have been accommodated or recognised within a single company and two separate entities were not necessary.

The terms of the agreement between the Taxpayer and ASDL

The Court considered that the agreement contained some unusual features. Significantly the Taxpayer was only required to pay 10% of each of ASDL's invoices with the remaining 90% to be paid at some unspecified time in the future with no interest being charged and payment being conditional on revenue generated by sales. The agreement was in effect an interest-free loan and as such the Taxpayer was not subject to a real economic burden. The Taxpayer

was therefore considered to be using the Act in a way Parliament did not intend. The higher than market hourly rate charged by ASDL was also considered to be an unusual feature of the agreement. The high rate had the effect of artificially increasing the amount of the invoices and the subsequent GST refund that could be claimed.

The fact that the Taxpayer had no independent source of funds

The Taxpayer had no independent source of funds other than through the receipt of the GST refunds. While this was on its own not considered to be sufficient to bring the arrangement within the ambit of section 76 of the Goods and Services Tax Act 1985, in combination with all the other factors noted above it did assume some significance for the Court.

Section 19D of the Goods and Services Tax Act 1985

Counsel for the Taxpayer argued that section 19D of the Goods and Services Tax Act 1985 evidenced Parliament's intention to mark out specific thresholds of time and value which it considered to be acceptable and unacceptable in relation to timing mismatches and the risk to the revenue. The Court rejected that contention.

JUDICIAL REVIEW: THE COMMISSIONER'S POWERS UNDER SECTIONS 16 AND 16B OF THE TAX ADMINISTRATION ACT 1994

Case	Avowal Administrative Attorneys Ltd & Ors v The District Court at North Shore & the Commissioner of Inland Revenue
Decision date	11 May 2010
Act(s)	Tax Administration Act 1994
Keywords	Section 16, blanket privilege claim, "book or document", double tax agreement

Summary

The access operation carried out by the Commissioner pursuant to section 16 of the Tax Administration Act 1994 (TAA) was used to obtain information which was necessary or relevant for the investigation of activities affecting New Zealand tax liabilities

Impact of decision

This decision confirms that:

a) the Commissioner's interpretation of the extent of his section 16 and 16B powers is correct

b) a preliminary screening on site will not necessarily be a prerequisite to a reasonable access operation (particularly where the Commissioner has obtained sufficient information under an earlier investigation to consider it necessary to copy information)

c) in the event the Commissioner faces a blanket claim of privilege, removal of the hard drives for inspection once the privilege claim is resolved is an appropriate action

d) a hard drive is a "book or document" for the purposes of section 16

e) the Commissioner is not under any obligation to undertake an access operation which not only complies with section 16 but also with the equivalent Australian provision, case law and practice guidelines.

Facts

On 8 November 2006, the Commissioner of Inland Revenue ("Commissioner") and the Australian Tax Office ("ATO") conducted simultaneous access operations on both sides of the Tasman. The operations followed a request by the ATO to the Commissioner in 2004 under Article 26 of the Australia-New Zealand Double Tax Agreement ("DTA"). The ATO provided background information which indicated that a number of entities based in or operating in New Zealand were promoting, marketing and implementing a wide range of tax avoidance schemes.

Using his powers under section 16 of the Tax Administration Act 1994 ("TAA"), the Commissioner entered seven premises, both private and commercial, and removed hard copy documents and hard drives for copying. The taxpayers filed a judicial review on a number of grounds culminating in a High Court judgment in favour of the Commissioner on 22 December 2008.

A stay application (pending appeal) filed by the taxpayers was also dismissed on 1 May 2009. In addition, the taxpayers filed a further application to recall directions made by the High Court on 8 October 2009 (in relation to the process for reviewing the information obtained during the access operations). Venning J, in his judgment dated 21 December 2009, set out the refined procedure for the Commissioner to follow in reviewing the information.

The appellants appealed to the Court of Appeal against the High Court judgment of 22 December 2008 on the judicial review.

Decision

The Court of Appeal found in favour of the Commissioner.

Before considering the issues, the Court briefly considered the powers in sections 16 and 16B generally, and did note that the existence of section 16C of the TAA (which was not in force at the time of the access operations in this case) means that the issues in this appeal may now be of limited significance for future access operations carried out by the Commissioner.

Ground One – preliminary keyword searches

The search and inspection powers under section 16(1) are subject to section 21 of the New Zealand Bill of Rights Act 1990 and, like all public officials, the Commissioner must exercise the power in a manner that conforms to the reasonableness requirement of section 21. The Court noted that while a preliminary screening (as envisaged by the Australian Full Federal Court in *J M A Accounting*) was undoubtedly good practice, it was not a necessary prerequisite to a reasonable access operation under section 16.

This issue was then considered separately in relation to the Auckland and Motueka sites.

The Auckland site

The taxpayer had argued that despite the blanket privilege claim made at the Auckland site, the Commissioner should still have continued to undertake a preliminary screening to determine the relevance of any information rather than remove the hard drives. The Court, however, concluded that the Commissioner had acted reasonably in relation to the Auckland site.

The Court again stated that a preliminary screening was not necessary. It noted further that in this case it may be that the prior investigation carried out by the Commissioner provided him with a sufficient basis for considering inspection necessary. However, as neither the High Court nor the Court of Appeal had heard argument on that aspect, the Court decided not to make a finding on that basis.

The Court referred to the taxpayer's assertion that section 16B provides that the only documents that could be removed were those considered necessary or relevant under section 16 and concluded that it was not apparent that section 16B needed to be read down this way. In any event, the Court concluded that once the privilege claim was made, it was open to the Commissioner to determine that it was necessary to remove the hard drives to inspect later once the privilege claim was resolved.

The Court also dismissed the argument raised by the taxpayer that the Commissioner was unable to remove the hard drives and give them to the District Court pursuant to section 20(5) (rather that the District Court had to request the information). The Court held that the power of the District Court to require the production of information relating to a privilege claim does not restrict the ability of the Commissioner to lodge the information voluntarily with the Court. Further, the Commissioner's actions were a pragmatic and sensible approach to ensuring the privilege claims were respected without prejudicing the access operation.

The Motueka site

The taxpayer had argued that the Commissioner did not intend to carry out preliminary screening at the site. In addition, the Commissioner's argument that the hard drives were cloned because encryption software was detected was incorrect as there was no evidence that the encryption was operative. Further, the Commissioner should first have asked the proprietor to remove the encryption before determining the relevance of the information on the hard drives.

The Court determined that it was the intention of the Commissioner to undertake preliminary screening unless encryption rendered that operation futile. Further, given the history of the investigation, it was reasonable for the Commissioner to conclude that hard drives containing encryption software would provide relevant information. In addition, the Court held that the Commissioner did not have to seek the assistance of the proprietor to remove the encryption given the Commissioner was sceptical about the outcome of any request.

Ground Two – operation solely for the ATO

The Court concluded that while it was acknowledged that the ATO had initiated an exchange of information, the access operation was carried out some two years after that initial exchange, pursuant to a New Zealand tax investigation and was for the purposes, at least partly, of investigating conduct affecting the New Zealand tax base and collection of tax in New Zealand.

Sections 81 and 88 of the TAA

The taxpayer had argued that the Commissioner has no obligation to supply information to the ATO, pursuant to Article 26 of the DTA, unless the information could have been obtained by the Federal Commissioner of Taxation in Australia utilising the same operation undertaken in NZ. The Court rejected this and held that it was clear that Article 26 simply provides that the Commissioner is not obliged to pass on information that would not be accessible under Australian law or practice. The Court went further to suggest that it would be an absurd result if the Commissioner was required to carry out access operations which not only complied with section 16 but with the Australian equivalent provision, case law and practice guidelines.

In any event, the Court concluded that the information obtained from the access operation would be obtainable under the Australian equivalent provision and therefore the Commissioner was obliged to supply it to the ATO.

The Court also agreed with the Commissioner that the fact that Article 26 provided only that there was no obligation on the Commissioner to provide information does not

prevent the Commissioner from voluntarily doing so. However, the Court did note that, prima facie, section 88 requires secrecy be maintained unless the Commissioner is required to provide the information. However, the Court decided that it was unnecessary to conclude on this point given their earlier conclusion.

Ground Three – are hard drives "books or documents"?

The Court held that a "record" (for the purposes of the definition of "books or documents") includes both information as recorded and also the medium upon which the recording is made. Accordingly, a hard drive is a "record" and can therefore be cloned. The taxpayer had also asserted that a hard drive should be excluded due to the vast quantity of material it can hold but this distinction was rejected by the Court.

Ground Four – consent

Notwithstanding the fact that the Court had already concluded that the removal of the hard drives was permitted, the Court concluded that in any event Ms Chisnall (the Avowal representative present at the Auckland site) had consented to their removal.

Ground Five – advising on law reform

The Court accepted that there was no evidential basis for this finding by the High Court (in that it was not advanced by the Commissioner nor present in the warrant applications) but noted that this had no impact on the outcome of the present appeal.

Ground Six – contempt of NSW court

The Court firstly concluded that there was no evidence that the timing of the access operation coinciding with the criminal proceedings in Australia was "contrived" rather than merely coincidental. Further, the Court rejected the taxpayer's argument that the ATO requested information from the Commissioner who consequently acted in contempt. This was because the ATO gave an undertaking that no information derived from the section 16 access operations in New Zealand would be communicated to anyone associated with certain related criminal prosecutions. The Court noted that in this regard no information derived from the access operation was in fact exchanged by the time the criminal proceedings took place. The Court also rejected the taxpayer's assertion that the removal of a laptop hard drive belonging to Mr Petroulias from the Motueka site also resulted in a contempt in that it contained information relevant to the defence of the criminal proceedings.

Conclusion

The access operation carried out pursuant to section 16 was used to obtain information which was necessary or relevant for the investigation of activities affecting New Zealand tax liabilities.

QUESTIONS WE'VE BEEN ASKED

QB 09/06: GST – APPORTIONMENT OF THE COST OF BARE LAND FOR THE PURPOSES OF A CHANGE-IN-USE ADJUSTMENT

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

Question

We have been asked to clarify the Commissioner's position on apportioning the cost price of bare land for the purposes of section 10(8)(a). This question arises where land is purchased for the principal purpose of making taxable supplies and part is used for non-taxable purposes thereby giving rise to a deemed supply under section 21(1)(a).

Answer

The Commissioner considers that a pro rata method of apportionment of cost for the purposes of section 10(8)(a) will generally be appropriate for deemed supplies of bare land under section 21(1)(a).

However, where it is not realistic to attribute the same proportion of the cost to all parts of the land, a pro rata method of apportionment will be inappropriate.

Any method adopted, however, must be made on an intelligible basis, must be based on the facts as known at the time of purchase (*Lowe v CIR* (1981) 5 NZTC 61,006) and must not be too theoretical or artificial (*Lowe v CIR*; *CIR v Walker* [1963] NZLR 339).

Background

Where a registered taxpayer acquires land for the principal purpose of making taxable supplies in the course or furtherance of a taxable activity in New Zealand, the taxpayer can generally claim 100% of the input tax paid in acquiring that land. If the taxpayer uses part of that land for a non-taxable purpose (such as erecting a residential dwelling or erecting accommodation for farm workers), either in the GST return period in which the land is acquired or in subsequent periods, then they are deemed to have made a supply under section 21(1)(a) and must make an adjustment.

In these circumstances, the adjustment reflects the extent to which the land is used for non-taxable purposes. The taxpayer must return output tax on the deemed supply of land used for non-taxable purposes. Section 10(8) deems the value of any adjustment required under section 21 to be the lesser of the cost of those goods or services to the supplier or the open market value of the deemed supply.

The adjustment provisions in effect reduce the amount of any input tax claimed on the original acquisition to reflect any non-taxable use.

Legislation

Section 21(1)(a) provides:

(1) Subject to section 5(3), a registered person is treated as supplying goods and services in the course or furtherance of their taxable activity if—

(a) the person acquires or produces the goods and services for the principal purpose of making taxable supplies but applies the goods and services for a purpose other than that of making taxable supplies …

Section 21a provides:

(1) A registered person must determine the extent to which goods and services are applied for the purpose of making supplies other than taxable supplies according to:

(a) actual use; or

(b) an alternative method approved by the Commissioner if the method results in allocated amounts that are fair and reasonable.

(2) A registered person must determine the extent to which goods and services are applied for the purpose of making exempt supplies by either applying subsection (1) or using the formula:

$$\frac{\text{Total value of exempt supplies for taxable period}}{\text{Total value of all supplies for taxable period.}}$$

(3) A registered person must choose a method that ensures a fair and reasonable result.

Section 21C provides:

(1) A registered person to whom section 21(1) applies must attribute output tax to one of the following times:

(a) in the first taxable period in which goods and services are applied for a purpose other than that of making taxable supplies; or

(b) in each taxable period in which goods and services are applied for a purpose other than that of making taxable supplies; or

(c) in each year in which goods and services are applied for a purpose other than that of making taxable supplies.

(2) A registered person who applies subsection (1)(a) must make output tax attributions to reflect further changes in use of 20% or more.

(3) If subsection (1)(a) or (1)(c) applies, a registered person must reduce the output tax attributable by the amount of

> the output tax attributed to earlier taxable periods for the supply of the goods and services.
>
> (4) A person may change the time the person attributes output tax only with the Commissioner's approval.

Section 10 provides:

> (1) For the purposes of this Act the following provisions of this section shall apply for determining the value of any supply of goods and services.
>
> …
>
> (8) Where goods and services are deemed to be supplied by a person under section 5(3) and the goods and services were acquired before 1 October 1986, or where goods and services are treated as being supplied under section 21, the consideration in money for either supply shall be deemed to be the lesser of—
>
> (a) The cost of those goods and services to the supplier, including any input tax deduction claimed in respect of the supply of those goods and services to that supplier:
>
> (b) The open market value of that supply.

Discussion

A deemed supply of a part of a parcel of bare land under section 21 is valued under section 10(8) to be the lesser of the cost of the goods and services to the supplier and the open market value of the deemed supply. The phrase "the cost of those goods and services to the supplier" in section 10(8)(a) necessarily requires that the cost of the whole land be apportioned in order to determine the cost of the deemed supply.

Meaning of "cost"

The word "cost" is not defined in the Act. Therefore, it must be given its ordinary meaning. The *Concise Oxford Dictionary* (11th edition) relevantly defines "cost" as:

> n. the amount that something costs; the effort or loss necessary to achieve something.

In *Wilke v CIR* (1998) 18 NZTC 13,923 it was held, in the context of section 10(8), that "cost" means the money or money's worth given up to get something. Panckhurst J in *Wilke v CIR* adopted the reasoning of the Canadian Federal Court of Appeal in *Kettle River Sawmills Ltd v Minister of National Revenue* (1993) 64 NR 241, which states (at page 249):

> Cost means the money or money's worth which is given up by somebody to get something. It is generally viewed as an objectively determinable historical fact, the answer to the question 'how much was paid?'

Similarly, in *CIR v Lundy Family Trust & Behemoth* (2005) 22 NZTC 19,637 the Court of Appeal considered the meaning of the word "cost" in the context of section 10(8) and stated:

> The term "cost" would be ordinarily understood as the acquisition cost and we consider that is its meaning in the present context.

Valuation of which supply?

Section 10(8)(a) states that the value of a deemed supply may be the "cost of those goods and services to the supplier, including any input tax deduction claimed in respect of the supply of those goods and services to that supplier". It is considered that this refers to the original purchase price of the goods or services (in this case, bare land) apportioned to reflect the amount properly attributable to the deemed supply made under section 21(1).

Apportionment of "cost"

Section 10(8) operates to value a deemed supply arising out of a change in use adjustment under section 21. Section 21A applies to apportion the goods and services subject to a change in use adjustment between taxable and non-taxable use. Therefore, the Act envisages that sometimes only a part of goods or services acquired for taxable purposes may be applied to a non-taxable use. It is considered that it is possible, and indeed required by the legislation, to determine the cost or value of a part of an undivided whole when only the cost of the whole is known.

It is therefore necessary to consider how to apportion the cost of bare land for the purposes of section 10(8). Section 10(8) does not provide any basis for the apportionment of "cost" and there are no cases on apportioning the cost of land under section 10(8) of the Act, or in a GST context more generally.

Section 21A provides several apportionment methods. However, this section is concerned with how to apportion between taxable and non-taxable use to identify which part of the supply of goods or services (in this case land) has changed in use. Section 10(8), on the other hand, is concerned with valuing the deemed supply. The Commissioner considers that the fact that the land can be divided up between taxable and non-taxable use under section 21A, does not necessarily mean that the cost of the land can be divided up in the same proportions under section 10(8). This is because different parts of a parcel of land may contribute differently to the overall cost of that land. It is therefore considered that section 21A does not provide any direct guidance on apportioning "cost" under section 10(8)(a).

In the absence of any guidance from the Act or any GST cases, it is necessary to look outside the GST context. The leading case on the method of calculating profit for the purposes of income tax is *Lowe v CIR*. The Court in *Lowe v CIR* held that where the provisions of the Income Tax

Act do not specify how to calculate the income of the taxpayer, the income is to be calculated using commercially accepted principles and methods. If there is more than one alternative commercially acceptable method then the method which provides the "truer picture" of the taxpayer's income should be used.

The courts have also said that the method of apportioning cost must be reasonable (*Lowe v CIR*), commercially acceptable (*Lowe v CIR*; Barwick J (dissenting) in *FCT v McClelland* (1967–1969) 118 CLR 353 at 365; 60 ATC 4001; 15 ATD 204), and made on an intelligible basis (*Lowe v CIR*); but cannot be too theoretical (*CIR v Walker*; *Lowe v CIR*), artificial (*McClelland v FCT* (1967–1969) 118 CLR 353; 14 ATD 529; *Elsey v FCT* (1969) 121 CLR 99; 69 ATC 4115) arbitrary (*Lowe v CIR*; *Chapman v FCT* (1968) 117 CLR 167; *CIR v Walker*) or unjustifiable (*McGuiness v Commissioner of Taxation* (Cth) (1972) 3 ATR 22; 72 ATC 4023). However, the courts have not provided more guidance on these features. Nevertheless, the case law is useful in so far as it provides judicial comments on the appropriateness of various methods of calculation used in specific circumstances. Ultimately, it would appear that the validity of a method of calculation will depend upon the particular circumstances of each case.

In the context of section 10(8) and bare land, the Commissioner considers the pro rata method would generally give the truer picture. Courts are reluctant to use methods that are too theoretical or artificial. The pro rata method, also called the area method, takes the proportion of land subject to the deemed supply and uses it to apportion the purchase price of the whole block of land in order to calculate the "cost" of the part.

The Commissioner considers that the courts will generally accept a pro rata approach under section 10(8), even when the land is not completely uniform. However, it is possible that the courts may depart from a pro rata approach and accept some other method in situations where there is evidence that it would not be realistic to attribute the same proportion of the cost to all parts of the land.

These situations could include where:

- a parcel of land is not uniform in nature because it is made up of areas of significantly different features (*Elsey v FCT*). For example, flat pasture land, land bordering on a beach or lake-side, mountainous land, or swamp;
- part of the land is zoned differently under a district plan (*CIR v Walker*); or
- a right attaches to a specific part of the land, for example a right of way or easement.

In addition, generally, where the parties explicitly agree in the sale and purchase agreement that part of the total cost of the land attaches to a part disproportionately in relation to its size due to one or more of the factors above, then that will be evidence of the cost of the different parts of the land.

The actual future use of the land will not be a factor that influences whether a particular method of apportionment is appropriate (*Lowe v CIR*).

Any method of apportioning cost under section 10(8) must be based on the original cost price of the land.

Whether valuations can be used to determine "cost"

One alternative method to pro rata is where valuations are used to apportion the cost price of land to determine how much should be attributed to the land subject to the deemed supply. The "cost" of the deemed supply would be calculated with reference to the respective land valuations (as at the time of purchase) of the land used for taxable purposes and the land used for non-taxable purposes. The valuations of the different parts of that land would be used to divide up the cost. Such valuations must be based on facts known at the time the land was purchased, and cannot take into account the actual future use of the land. Such valuations may, depending on the particular circumstances, need to take into account the fact that the land is one undivided whole.

It might be argued that using valuations to identify the cost of part of an area of land cannot be correct because it might mean that the two bases for valuation in section 10(8)—cost and open market value—would effectively be the same.

However, the "cost" and "open market value" options are different enquiries. The Commissioner considers that the two bases for valuing the deemed supply under section 10(8) provide distinct methods for determining the value of a deemed supply under section 21(1). The market value is the current market value of the deemed supply at the time of the deemed supply, and the cost is the original cost to the purchaser of the land (deemed later to be supplied) when the whole of the land was purchased. There is no guidance in the Act regarding appropriate methods of apportioning "cost" where only part of the land is subject to a deemed supply. The Commissioner considers that valuations can be used to apportion cost, but only if they reflect the value of the different parts of the land at the time the land was purchased.

Examples

Example 1

A person registered for GST buys a 10 hectare block of bare land for $200,000 (including GST) for his market gardening business. The land is made up of flat pasture land and rolling hills. The new owner claims an input tax deduction for the GST paid on the purchase of the land. Some months after purchasing the property, the owner decides to set aside 1 hectare of the land for a house for his family. The current market value of similar 1 hectare sections in the area is $50,000.

The owner must make an adjustment of the GST input tax deduction claimed on purchasing the land and return an amount of output tax that relates to the land set aside for the family home. Section 21C gives the taxpayer the option to make a one-off adjustment, a periodic adjustment, or an annual adjustment. The taxpayer chooses to make a one-off adjustment. The amount of output tax that must be paid on the deemed supply is calculated by applying the tax fraction to the value of the deemed supply. Under section 10(8), the value of the deemed supply is the lesser of the cost or the market value of the deemed supply of land.

In this situation it would be appropriate to calculate the cost of the land set aside for the family home by apportioning the cost of the whole parcel of land on a pro rata basis.

A pro rata method of calculating the "cost" of the 1 hectare section results in a price per hectare of $20,000. As the "cost" of the section is less than its market value of $50,000, the value of the deemed supply under section 10(8) is $20,000.

Example 2

A person registered for GST buys a 150 hectare block of land adjacent to his dairy farm for $1.5 million (including GST) and claims an input tax deduction for the GST paid on the purchase of the land. The land is flat pasture land near the coast close to a popular holiday destination. One year after purchasing the property to extend his farm, the owner decides to set aside the hectare of land that has access to the beach for the family home. The current market value of 1 hectare sections with beach access is $250,000.

The owner must make an adjustment of the GST input tax deduction claimed on purchasing the land and return an amount of output tax that relates to the land used for the family home. Section 21C gives the taxpayer the option to make a one-off adjustment, a periodic adjustment, or an annual adjustment. The taxpayer chooses to make a one-off adjustment. The amount of output tax that must be paid on the deemed supply is calculated by applying the tax fraction to the value of the deemed supply. Under section 10(8), the value of the deemed supply is the lesser of the cost or the market value of the deemed supply of land.

Using a pro rata method, the "cost" of the beach-front section would be $10,000. However, at the time that the property was purchased, similar sized beach-front sections in the area were sold for $200,000, and local dairy-farm land sold for $12,000 per hectare. In this situation, a calculation of "cost" as a price per hectare will be inappropriate because it would not accurately reflect the cost attributable to the land with beach access compared with the rest of the farm land.

A more appropriate method is to identify the respective market values of the farm land and the residential section at the time of the original purchase and calculate what percentage of the aggregate market value of the land relates to the residential land. This percentage is then applied to the original cost of the land to determine the "cost" of the residential land.

The market value of the farm land at the time of purchase (based on the sale prices of local dairy-farm land) was $1.788 million for the 149 hectares of farm land at $12,000 per hectare. The market value of the 1 hectare section at the time of purchase (based on the market value of similar beach front sections at the time of purchase) was $200,000. Therefore the total market value of the land at the time of purchase was $1.988 million. (The owner purchased the property for below market value.)

The market value of the residential land ($200,000) is divided by the total market value of the whole parcel of land ($1.988 million) in order to calculate a percentage. In this situation, the market value of the residential land is 10.06% of the market value of the whole parcel of land. This percentage should then be applied to the purchase price of the whole land ($1.5 million) to identify the proportional values of the farmland and residential land and so calculate the "cost" of the residential land. This results in the "cost" of the 1 hectare section being $150,900.

Market value of 149 hectares of rural land	$1.788m
Market value of 1 hectare of residential land:	$200,000
Total aggregate market value:	$1.988m

Percentage of the total market value of the land attributable to the residential land:

$$\frac{\$200,000}{\$1.988m} \times 100\% = 10.06\%$$

Percentage of the total market value of the land attributable to the residential land applied to the original purchase price:

$$10.06\% \times \$1.5m = \$150,900$$

Therefore, under section 10(8), the "cost" of the beach-front section under paragraph (a) is $150,900, and its market value at the time of the deemed supply under paragraph (b) is $250,000. As the "cost" of the section is less than its market value, the value of the deemed supply under section 10(8) is $150,900.

The above answer necessarily sets out general principles only. The facts of particular cases always need to be considered carefully, and it may be necessary to obtain advice from a tax advisor.

QB 10/04: SHORTFALL PENALTY FOR EVASION OR A SIMILAR ACT – KNOWLEDGE REQUIRED AND INTERPRETATION STATEMENT IS0062

Section 141E(1)(d) to (f) – shortfall penalty for evasion or similar act – Tax Administration Act 1994

All legislative references are to the Tax Administration Act 1994.

Question

1. We have been asked whether paragraphs (d) to (f) of section 141E(1) require knowledge of the unlawfulness of the act in question. It has been suggested that the Interpretation Statement for the shortfall penalty for evasion or a similar act is potentially ambiguous on this point.

Answer

2. Knowledge of the unlawfulness of the act is necessary for paragraphs (d) to (f) of section 141E(1) to apply.
3. The Commissioner accepts that the first sentence in paragraph 4.54 of the Interpretation Statement for the shortfall penalty for evasion or a similar act is potentially ambiguous when read in isolation. However, paragraph 4.71 of the Interpretation Statement and section 141E(1) make it clear that knowledge of the unlawfulness of the act is necessary for paragraphs (d) to (f) of section 141E(1) to apply.

Background

4. The Commissioner issued the Interpretation Statement "Shortfall penalty—evasion" (IS0062) in November 2006 and published it in *Tax Information Bulletin* Vol 18, No 11 (December 2006). The Interpretation Statement concerns the interpretation of section 141E(1).
5. Section 141E(1) currently states:

> (1) A taxpayer is liable to pay a shortfall penalty if, in taking a tax position, the taxpayer—
>
> (a) Evades the assessment or payment of tax by the taxpayer or another person under a tax law; or
>
> (b) Knowingly applies or permits the application of the amount of a deduction or withholding of tax made or deemed to be made under a tax law for any purpose other than in payment to the Commissioner; or
>
> (c) knowingly does not make a deduction, withholding of tax, or transfer of payroll donation required to be made by a tax law; or
>
> (d) Obtains a refund or payment of tax, *knowing that the taxpayer is not lawfully entitled* to the refund or payment under a tax law; or
>
> (da) attempts to obtain a refund or payment of tax, *knowing that the taxpayer is not lawfully entitled* to the refund or payment under a tax law; or
>
> (e) Enables another person to obtain a refund or payment of tax, *knowing that the other person is not lawfully entitled* to the refund or payment under a tax law; or
>
> (f) attempts to enable another person to obtain a refund or payment of tax, *knowing that the other person is not lawfully entitled* to the refund or payment under a tax law—
>
> (referred to as **evasion or a similar act**).
>
> [Emphasis added]

6. Minor amendments have been made to section 141E since the Interpretation Statement was issued. However, those amendments do not affect the analysis.
7. The provisions of paragraphs (d) to (f) are explicit that the relevant act must be done "knowing that [the person] is not lawfully entitled" to the refund or payment.
8. The Interpretation Statement discusses *Case W3* (2003) 21 NZTC 11,014. In *Case W3* Judge Barber states (at page 11,025) that "knowledge of the existence of the facts in question without knowledge of the unlawfulness of an act will be sufficient". (See also *CIR v Gordon* (1989) 11 NZTC 6,082.) The Interpretation Statement then draws the following conclusions from *Case W3* at paragraph 4.54:

> 4.54 **Although *Case W3* was on paragraph (b) of section 141E(1), the observations on "knowingly" are applicable to all the paragraphs of section 141E(1) which use that term.** It can be seen that many of the points made are consistent with the discussion above on "evasion", however, unlike evasion it does not require any "blameworthy" intent to breach a law that is either known or suspected to exist. "Knowingly":
>
> - requires knowledge of the doing of the act (or of the omission) that amounts to a breach;
> - is a subjective test;
> - can be satisfied by recklessness, but
> - negligence or carelessness is insufficient to satisfy the test.
>
> [Emphasis added]

9. The first sentence in paragraph 4.54, when read in isolation, could be interpreted to mean that knowledge of only the existence of the facts described in paragraphs (d) to (f) of section 141E(1) is required.

This sentence, along with the first bullet point of paragraph 1.5 of the Interpretation Statement, could be viewed as inconsistent with the legislative requirements of this section.

10. However, as outlined in paragraph 4.71 of the Interpretation Statement, the correct interpretation is that paragraphs (d) to (f) of section 141E(1) require a taxpayer to have knowledge of the unlawfulness of the particular act in question. Paragraph 4.71 of the Interpretation Statement states:

> 4.71 **Paragraphs (d), (da), (e), and (f) relate to the obtaining of a refund or payment of tax, knowing that there is no entitlement to that refund or payment of tax.** Paragraphs (d) and (da) provide that the penalty will apply whether or not the taxpayer is successful in obtaining the refund or payment of tax. Paragraphs (e) and (f) provide that the penalty will also apply to a person who enables or attempts to enable another person to obtain a refund or payment of tax.
>
> [Emphasis added]

11. Therefore, paragraph 4.71 of the Interpretation Statement makes it clear that knowledge of the unlawfulness of the act is necessary for paragraphs (d) to (f) of section 141E(1) to apply.

12. Further, nothing in paragraph (b) of section 141E(1) requires a taxpayer to know that they are acting unlawfully, which is why Judge Barber in Case W3 held that knowledge of the existence of the facts is sufficient. However, paragraphs (d) and (da) of section 141E(1) expressly require a taxpayer to know that they are not lawfully entitled to the refund or payment under a tax law. Similarly, paragraphs (e) and (f) of section 141E(1) expressly require a taxpayer to know that another person is not lawfully entitled to the refund or payment of tax under a tax law. Therefore, section 141E(1) itself also makes it clear that knowledge of the unlawfulness of the act is necessary for paragraphs (d) to (f) of section 141E(1) to apply.

13. Note that this Question We've Been Asked considers only the requirements for paragraphs (d) to (f) of section 141E(1). Other paragraphs have different requirements, which are set out in the Interpretation Statement.

ITEMS OF INTEREST

MAKING TAX EASIER – GOVERNMENT CONSULTATION JUNE 9 TO 23 JULY 2010

On June 9, Revenue Minister Peter Dunne launched a public online consultation forum and discussion document on changes to the way taxpayers deal with Inland Revenue.

Before any changes are made, the Government is seeking wide comment on proposals. The "Making tax easier" online forum is open now for discussion at **www.ird.govt.nz/makingtaxeasier**

"Making tax easier" discusses simplifying Inland Revenue's systems and processes to provide more responsive online services, reduce the amount of paper required, provide tailored support for taxpayers and intermediaries, and reduce business compliance costs.

Under the proposals, individuals, businesses, employers and intermediaries would manage most of their tax affairs (and social entitlements) online, through their own secure space on the Inland Revenue website, in an approach like internet banking. Rapid responses and confirmation would aid certainty in dealing with tax.

For businesses and employers, new payroll software would manage a range of routine PAYE tasks, including the employer monthly schedule. Software that updates and exchanges information with Inland Revenue systems could automatically correct most current errors in PAYE information before it is sent.

PAYE deducted each pay day would be accurate and a final tax for many people in full-time work, although annual square-ups would be retained for other groups of workers and those with other income.

Further proposals cover sharing some information—with appropriate privacy safeguards—with other government departments, to reduce compliance costs and make it easier for people changing employment, going on parental leave, or updating their student loan repayments.

Consultation is being managed for the Government by Inland Revenue, and will remain open until 23 July.

In addition to the online forum, the formal discussion document is available to download from **www.taxpolicy.ird.govt.nz**, or by writing to:

Policy Advice Division
Inland Revenue
PO Box 2198
Wellington 6140

REGULAR CONTRIBUTORS TO THE TIB

Office of the Chief Tax Counsel

The Office of the Chief Tax Counsel (OCTC) produces a number of statements and rulings, such as interpretation statements, binding public rulings and determinations, aimed at explaining how tax law affects taxpayers and their agents. The OCTC also contributes to the "Questions we've been asked" and "Your opportunity to comment" sections where taxpayers and their agents can comment on proposed statements and rulings.

Legal and Technical Services

Legal and Technical Services contribute the standard practice statements which describe how the Commissioner of Inland Revenue will exercise a statutory discretion or deal with practical operational issues arising out of the administration of the Inland Revenue Acts. They also produce determinations on standard costs and amortisation or depreciation rates for fixed life property used to produce income, as well as other statements on operational practice related to topical tax matters.

Legal and Technical Services also contribute to the "Your opportunity to comment" section.

Policy Advice Division

The Policy Advice Division advises the government on all aspects of tax policy and on social policy measures that interact with the tax system. They contribute information about new legislation and policy issues as well as the Orders in Council.

Litigation Management

Litigation Management manages all disputed tax litigation and associated challenges to Inland Revenue's investigative and assessment process including declaratory judgment and judicial review litigation. They contribute the legal decisions and case notes on recent tax decisions made by the Taxation Review Authority and the courts.

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