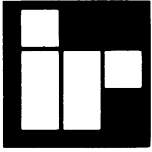

Public Information Bulletin

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1982 LEGISLATION

This publication contains answers to a number of questions which have been raised since Public Information Bulletin Number 120 was printed.

The information contained in these answers was not covered in PIB 120.

1982 LEGISLATION

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INCOME TAX AMENDMENT ACT 1982

Section 8 - Principal Income Earner Rebate (Section 50B of principal Act)

Question When can National Superannuitants claim the principal income earner rebate?

Answer The rebate can be claimed in the returns of income filed by or on behalf of National Superannuitants in the year they first receive National Superannuation and the year of death (except where National Superannuation commences on 1 April or death occurs on 31 March). The rebate is calculated in the ordinary way on the income derived during the whole year.

Sections 8 and 13 - Principal Income Earner Rebate (Sections 50B and 53C of the principal Act)

Question 1 In grossing up the family income for the purposes of the family rebate, are incomes of both husband and wife grossed up to full year equivalents and on what basis are they grossed up?

Answer The incomes of both husband and wife are grossed up for the purpose of the rebate. The grossing up is based on the period of time each taxpayer is in the country, not on the basis of the length of time employed.

Question 2 What is the relationship between grossing up of the principle income earner rebate and the family rebate and section 56?

Answer The correct treatment will depend on whether the taxpayer is "an absentee personally present in New Zealand" or a "resident" during the period he is personally present in New Zealand.

Under section 37 an "absentee" means a person who has not been a "resident" during any part of the income year.

Under section 241 a "resident" is defined as a person who, either -

(a) has his permanent place of abode in New Zealand, or

(b) is personally present in New Zealand for a continuous period of 365 days or more.

This means that for a person who enters or departs from New Zealand during the income year and is resident in New Zealand during his presence (e.g., he arrives with the intention of taking up permanent residence) the income is grossed up to its annual equivalent under the new sections 50B and 53C of the Act. Section 56 has no application in this case as the taxpayer is not an absentee, by virtue of the fact that for a part of the income year he was resident in New Zealand.

On the other hand a person who enters or departs from New Zealand during the income year and was an "absentee" during his stay (e.g., a person on a 3 month working holiday in New Zealand) is treated as follows:

(a) Firstly, that person's income is grossed up to its annual equivalent under the provisions of sections 50B and 53C of the Act and the rebate is calculated.

(b) Secondly, section 56 allows this rebate subject to an apportionment based on the period of time the person was employed in New Zealand.

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INCOME TAX AMENDMENT ACT (NO.2) 1982

Section 4 - Bonus Issues and Capital Profits (Section 4 of principal Act)

Question 1 Bonus Issues

Does section 4(1)(ca) cover the situation where a bonus issue and a return of capital are both made within the same income year?

Answer Section 4 of the Income Tax Amendment Act (No.2) 1982 expresses the 10 year period as 10 income years, whereas it should have been expressed as 10 calendar years ending on the day the return of capital was made.

Theoretically, therefore, it would be possible for a company to make, within the same income year, both a bonus issue and a return of capital applicable to that bonus issue without either the bonus issue or the subsequent return of capital attracting any tax.

However, since the legislation was passed, the Government has announced that legislation will be introduced this year to:

(1) Amend the legislation to remedy the defect in the period of 10 years as it is expressed at present.

(2) Apply the amendment in respect of any bonus issue made on or after 1 April 1982.

Question 2 Does a return of capital include a commercial advance made to a shareholder within 10 years after a bonus issue and if so, where the shareholder subsequently repays that advance, is the liability to the tax incurred on the amount of the advance (which was deemed to be a dividend) able to be reversed?

Answer Any loan or advance made after a bonus issue, on terms which are not commercially supportable, e.g., interest free is, in the absence of any revenue or capital reserves at the time of making the loan or advance, effectively a subsequent return of capital to the shareholder and falls to be treated as a dividend under the new paragraph (ca) of section 4(1) of the Income Tax Act.

This is because any such loan made to a shareholder must first be treated as a distribution of profits, i.e., of revenue and capital reserves, and taxed as a dividend. When these reserves have been extinguished, any portion of the loan which has not been treated as a distribution of profits is a return of capital to which section 4(1)(ca) applies.

In a case where the advance (or any portion of the advance) is not a bona fide investment and is in fact a return of capital any subsequent action to repay the advance does not change the nature of the original transaction.

Question 3 **Capital Profits**

Where a company disposes of an asset at a profit to a related company will that profit be available for distribution as a capital profit when the new owner sells the asset to an unrelated party outside the group?

Answer The profit arising from the intra-group transaction does not become available for a section 4(5) "tax free" distribution when the asset is eventually sold outside the group.

Question 4 What will be the requirements for the identification of capital reserves existing at 1 April 1982, in the light of the new section 4(5A)?

Answer Where a specified company had, at 1 April 1982, capital reserves which comprised a combination of capital gains arising from transactions with unrelated as well as related persons, then the specified company will need to identify the respective components of the capital reserves when making a capital distribution to shareholders.

Only distributions from that part of a capital reserve which arises from transactions with unrelated persons will qualify for the purposes of a tax free distribution under section 4(5). The source of the distribution should be clearly identified in the annual accounts and in the statements which accompany the annual tax return.

Question 5 Company B created a capital reserve from the sale, before 1 April 1982, of real property to a related Company C. Company B distributed a dividend from the capital reserve to its parent Company A, prior to 1 April 1982. Company A distributes the dividend to its shareholders after 1 April 1982. What is the tax status of the distribution by parent Company A to its shareholder?

Answer Having regard to the decision in Smout v. CIR (1982) NZLR, it is accepted that the new section 4(5A) would not apply to a distribution received by a company prior to 1 April 1982 even though that distribution so received was not passed on to the individual shareholders of the recipient company until after that date. The Department would, however, continue to apply the rules set out in PIB 117 in relation to the application of the tax avoidance provisions of section 99 to the kind of situation set out in this question.

Section 14 - Standard Value of Livestock (Section 86(2A) of the principal Act)

Question 1 Does the section apply to a taxpayer who purchased a farm in the 1981 income year if he purchases additional livestock in the 1983 income year to further stock that farm?

Answer — No. The section applies only to a taxpayer who commences or recommences to derive income from livestock or who, being a taxpayer who derives income from livestock, acquires additional land, brings land into production, or substantially increased production,on or after the 1st day of his income year commencing 1 April 1982. It does not apply to other farmers who simply purchase additional livestock.

Question 2 — Does the section apply to an investor who purchases livestock during the 1982/1983 income year if that person had never previously derived income from livestock?

Answer — The section does apply as the taxpayer commenced to derive income from livestock during the income year.

Question 3 — Does the section apply to an investor who has derived some income from livestock in previous years and who purchases a significant number of additional livestock during the 1982/1983 income year?

Answer — The section will not apply in these circumstances. The taxpayer commenced deriving income from livestock prior to the commencement of the 1982/1983 income year, and he has not acquired additional land, or brought further land into production or substantially increased production during that year.

Question 4 — Is a taxpayer who sells his farm and is unable to purchase a suitable replacement farm for, say, 8 to 12 months, regarded as having recommenced to derive income from livestock when he purchases the new farm?

Answer — No. The expression "recommences to derive income from livestock" contemplates a situation where a taxpayer, having derived income from livestock, evidences, such as by taking up some other occupation, that he has ceased to derive income from livestock and later decides to return to farming.

It would also not affect the taxpayer who decides to have a holiday between the sale of one farm and the purchase of the replacement.

Question 5 — How should section 86(2A) be interpreted?

Answer — The amendment to section 86 introducing subsection (2A) is based on the Budget announcement that to remove one of the obvious avenues for tax avoidance, new farmers and those acquiring additional land would be required to progressively write stock purchases down to a standard value.

When interpreting the section regard must be had to this principle. In this context the criterion that "additional farming livestock" must have been purchased requires further clarification.

"Additional farming livestock" is the livestock purchased to stock the additional land or the land that is brought into substantially increased production. Additional farming livestock purchased to stock existing farm land, or land which has not been brought into production or substantially increased production since the commencement of the 1982/83 income year, is not covered by subsection (2A).

Question 6 — How is the phrase "....brings (any land) into...substantially increased production..." to be interpreted?

Answer — In bringing land into "substantially increased production" a farmer is likely to be involved in significant expenditure of a capital nature incurred in breaking-in and developing that land. The claiming of significant development expenditure on existing land coupled with purchases of livestock resulting in higher numbers of livestock on hand at the end of the year will prima facie indicate that land has been brought into production or substantially increased production. In this context, "substantially" connotes an increase that is sizeable, material, not minor, in relation to former production.

Question 7 — What is the meaning of the phrase "....farming livestock (not being replacement livestock)...."?

Answer — Two classes of taxpayer are covered under the progressive write-down provisions:

- Those covered under paragraph (a) of subsection (2A), i.e., taxpayers who commence or recommence to derive income from livestock (other than dealing) and

- Those covered under paragraph (b) of subsection (2A), i.e., taxpayers who already derive income from livestock and either bring into production, etc., any land or acquire additional land for the purpose of deriving income from livestock.

Where a taxpayer is covered under paragraph (a), the livestock that are subject to the progressive write-down provisions are:

- All livestock purchased in the income year of commencement or recommencement (there being, in that year, no "replacement stock"), and

- Livestock purchased in any of the 3 income years following the income year of commencement or recommencement that has not been purchased to simply replace livestock owned at the end of the previous year.

Inset

Where a taxpayer is covered under paragraph (b) and has brought into production or substantially increased production any land, the livestock that are subject to the progressive write-down provisions are:

- All livestock purchased in the income year in which the land was brought into production, etc., for use in stocking that land, and

- Livestock purchased in any of the three following income years for use in stocking that land but not including purchases to replace livestock owned at the end of the previous year.

Similarly, where a taxpayer is covered by paragraph (b), and has acquired additional land, stock that are purchased for use on that land in the income year of acquisition and the 3 following income years (not including stock purchased to replace livestock owned at the end of the previous year) are subject to the progressive write-down provisions.

Question 8 Prior to the introduction of the progressive write-down provisions, farming taxpayers were able, by choice, to defer the write-down of stock to standard values to such extent as would preserve entitlement to tax rebates, etc. Are similar arrangements permissible in terms of the new provisions bearing in mind that the livestock must be written down to the standard value by the end of the second year following the year of purchase?

Answer If a taxpayer wishes to defer the writing down of livestock to standard values, by a greater degree than that provided by the progressive write-downs, he has the following options:

(i) He may fix a standard value (say, in the year of purchase) and choose not to write the livestock down to that standard value until the third income year of ownership of that stock (as required by subsection (2A)).

(ii) He may fix a standard value higher than that which he would eventually wish to adopt, write-down to that value by the end of the third year of ownership, and in a later year seek the Commissioner's agreement to a lower, more appropriate, standard value which can then be adopted as soon as the taxpayer desires (after the end of the 3rd year).

(iii) He may choose not to seek the fixing of a standard value until sometime after the third year of ownership of the livestock, the taxpayer then being able to write the livestock down to the standard value adopted, immediately.

Section 23 - Sale of Property Within 10 Years (Section 129 of the principal Act)

Question 1 Does a farming company which sells a farm within 10 years of purchase (thereby invoking the interest and farm development expenditure recovery provisions in section 129) qualify for the relief measure available to farmers under section 129(5) if it purchases a replacement farm within 12 months?

Answer Yes. There is nothing to stop any taxpayer, be it a company, trust or individual, from qualifying for the "first sale" relief available under subsection (5) of section 129 in respect of the first sale after 31 March 1983 of a farm or farm land, by that taxpayer, that is caught by the 10 year rule. The taxpayer must, of course, still satisfy the requirements of subsection (5). These include the requirement that the replacement farm land acquired by the taxpayer be an "economic farm property". In this connection the capability of the property to return a livelihood (if it were farmed by an individual) is still relevant in relation to the replacement farm land itself.

N.B. For the subsection (5) relief to apply the replacement farm must be purchased and farmed by the same taxpayer (or the same taxpayer together with someone else). Accordingly, if an individual farmer sells a farm and the replacement property is purchased by a company, of which he may be the major shareholder, the relief cannot apply.

Question 2 Where the Department has applied the "dual purpose" test to a rental venture and limited the deduction for expenditure incurred to the amount of the rental income received, how does the Commissioner calculate the interest to be recovered in the event of the property being sold within the 10 year period?

Answer In such situations the amount of interest deemed to have been allowed, and which would be subject to recovery, will be calculated on a pro rata basis.

Example

Gross Rents		$4,000
Rates, Insurance, etc.	$ 900	
Repairs and Maintenance	800	
Interest	2,000	
Depreciation	1,300	5,000
Loss		$1,000

∴ Expenditure disallowed = $1,000.

For section 129 purposes the interest allowed in respect of the above year is:

$$\frac{2000}{5000} \times 4000 = \$1,600$$

In the event of an actual apportionment being made, by the taxpayer, of rented property expenditure between income producing purposes (deductible) and non-income producing purposes (non-deductible), recovery of interest under the 10 year rule will be based on the amount of the interest actually allowed as a deduction in calculating assessable income.

Question 3

Is mortgage interest that has been allowed as a deduction in connection with a home study claim by a salary and wage earner subject to the new interest recovery measures if the home is sold within 10 years of purchase?

Answer

Yes. The new interest recovery measures apply to any sale of land (or land and buildings) made within 10 years of purchase where a deduction for interest (as defined) has been allowed in calculating the assessable income of the taxpayer in respect of money borrowed to purchase that land.

The claim for home study expenses under paragraph 7 of the Fourth Schedule to the Income Tax Act 1976 by salary and wage earners is in respect of expenditure incurred in gaining or producing assessable income from employment (section 105(2)(b)(i)), and mortgage interest claimed as a deduction therefore comes within the scope of section 129(2)(b) and (f).

Question 4

Where money has been borrowed by a taxpayer for more than one purpose or a property has been purchased from a "pool of funds" how is the amount of the recoverable interest deductions determined?

Answer

The interest recovery provisions can be applied only to the extent that it can be established that a "deduction for interest", as defined in section 129, has been allowed in relation to the property sold.

Where the property has been purchased from a "pool of funds" and interest has been claimed in respect of some or all of the pool of funds, the Department will expect the taxpayer to make a reasonable apportionment or allocation of that interest relating to the property purchase.

It is not possible to lay down any hard and fast rules as to the basis of apportionment which will be accepted by the Department as the proportion of the interest deductions recoverable in such situations can only be arrived at on a case by case basis.

Question 5 (a) When a new partner is admitted to a partnership which owns land and he becomes entitled to a share in the assets, or the proceeds of any sale of the assets, of the partnership, does this constitute a "sale or other disposition" of land to which section 129 applies? If so, what proportion of the land has been disposed of and what interest and farm development expenditure is subject to recovery?

(b) What is the position where an existing partner leaves the partnership and his share is taken up by the remaining partners?

Answer (a) The introduction of a new partner generally involves a sale or other disposition of "land" by the existing partners whose respective shares or interests in the partnership are reduced by the admission of the new partner. The word "land" is defined in section 129 as including "any estate or interest in land whether legal or equitable, corporeal or incorporeal, freehold or chattel" and the admission of a new partner involves the disposition of such an interest in land. The proportion of the land disposed of by each of the existing partners equates to the reduction of the individual partner's fractional or percentage share in the partnership.

Example

A partnership with three partners owning equal shares introduces a new partner and thereafter each of the four partners has an equal share in the new partnership. The shares in the partnership of each of the three original partners have been reduced from one-third to one-quarter. Each of these partners has therefore disposed of a one-twelfth interest in the partnership land. The interest and farm development expenditure deductions subject to recovery in the hands of each partner will also be calculated on the basis of one-twelfth of the total of those deductions allowed.

It will, of course, also be necessary to apportion the original purchase price of the land paid by the three partners to arrive at the excess. Similarly, the price paid by the incoming partner will have to be apportioned between the land and any other partnership assets.

Answer (b) In this situation the partner leaving the partnership is selling or disposing of his interest in the partnership land to the remaining partners. Similarly, as in the case of answer (a) above, the land disposed of and the deductions subject to recovery are in proportion to the share of that partner in the partnership.

Question 6 Subsection (5)(c) - Does the Commissioner have any discretion to extend the 12 month period during which the replacement "economic farm property" must be purchased?

Answer No. Where a replacement economic farm property is being acquired following the sale of the farm which is subject to section 129, that replacement property must be acquired within the 12 months following the date of the sale of that previous farm, for the subsection (5) relief to apply.

Section 32 - Loss Incurred in Specified Activities (Sections 188A and 188B of principal Act)

(A) Section 188A - Loss Incurred in Specified Activity

Question 1 Subsection (7) of the new section 188A enables the taxpayer to make an election in respect of the losses to be offset from two or more specified activities. It provides that where in an income year a taxpayer conducts two or more specified activities and incurs losses in respect of each of those activities the maximum amount of the loss that may be offset against other income derived in that year is $10,000 (s.188A(7)(f)). In such cases, paragraph (g) of subsection (7) allows the taxpayer to make an (irrevocable) election determining the amount of the loss from each specified activity that will be comprised in the $10,000 loss offset in that income year.

What is the position if the taxpayer chooses not to make the above election?

Answer In this event the provisions of section 19, which empower the Commissioner to determine whether, and to what extent, the loss from each activity is to be carried forward in accordance with the ground rules set out in s.188A(7), will apply. Therefore, in circumstances where a taxpayer incurs losses (say $15,000) in each of two specified activities, he may

(i) Take advantage of the election provision in s.188A(7)(g) and determine, with certainty, the amount of loss from each activity that will be offset against other income in the year incurred (e.g. that $7,000 from activity A and $3,000 from activity B be offset). The amount of loss available to be carried forward from each activity will then be determined by the amounts not so offset in accordance with paragraph (h); or

(ii) Not make the election provided for in s.188A(7)(g) but claim instead that a surplus loss in respect of each activity be carried forward to the next income year (e.g., that $8,000 be carried forward in respect of activity A, and $12,000 in respect of activity B).

(iii) Not make the election provided for in s.188A(7)(g) but merely claim that the combined surplus of losses over $10,000 from the specified activities be carried forward to the next income year (e.g., that a loss of $20,000 be carried forward). In such a case, the Commissioner is bound to make a determination as to how much of that total loss available to be carried forward relates to each specified activity.

Question 2 How does section 188A apply in the situation where a company, being a member of a specified group, incurs a loss from a specified activity to which section 188A applies, and seeks to pass that loss to another company in the group under section 191(5)?

Answer Section 191(5) was amended by last year's No.2 Amendment Act and is now subject to section 188A. The effect is that where a company incurs losses from specified activities to which section 188A applies, the total amount of losses from those specified activities which the loss company can nominate for offset against the income of group companies in any income year cannot exceed the $10,000 limitation.

(Note Losses from activities which do not come within the provisions of s.188A can be nominated for offset in the normal way.)

Question 3 Does section 188A prohibit the payment of a subvention payment to a company whose loss was incurred in a specified activity?

Answer Section 188A does not prohibit the payment of subvention payments. However, in the hands of the loss company the subvention payment is not income from a specified activity; it is simply deemed by section 191(7) to be assessable income derived by the payee company. As a consequence, losses from specified activities to which section 188A applies can be offset, against both the subvention payment and any income from other sources, to the extent of only the $10,000 limitation.

Question 4 What is the effect of excluding from the definition of specified activities the business of growing trees or plants (other than flowers) in respect of which the preparation of the land, and the planting and cultivation of the tree or plant, and the harvesting of the crop is accomplished within a period of 12 months?

Answer The exclusion will cover all annual crops such as maize, wheat, tomatoes, peas, onions, potatoes, tobacco and the majority of market garden crops. However, it will not include crops where the plant gives more than one annual crop (e.g. raspberries).

The rationale behind this exclusion was that where a taxpayer engaged in a specified activity which produces a profit decides to plant a crop of potatoes or some similar annual crop and the crop fails, the loss suffered will be able to be offset without limitation against the income from the specified activity. A further consideration was that in the case of cash cropping, the expenditure outlay produces revenue within a comparatively short time.

A taxpayer engaged in "annual cropping" is unable to fulfil the conditions which would bring him within the definition of "existing farmer" because his livelihood and sole or principal source of income will not consist of only a specified activity or specified activities. He will be unable to offset against his cash cropping income a loss to the extent that it exceeds $10,000, suffered in any specified activity which he commences subsequently. For example, where a market gardener diversifies into berry fruits the offset of any loss in this specificed activity will be limited to $10,000.

Where in any income year a taxpayer who has in previous years qualified as an existing farmer undertakes "annual cropping", his qualification as an "existing farmer" will need to be re-examined.

Thus a specified activity that previously qualified as an "Established Activity" may, because of the taxpayer undertaking "annual cropping" and thereby no longer qualifying as an existing farmer, cease to fulfil the requirements of an Established Activity in a particular income year. Consequently the $10,000 loss limitation would apply.

Question 5

Where a taxpayer has prior to the 1983/1984 income year incurred development expenditure under section 127 and elects under the proviso to subsection (2) to carry forward the deduction to later income years, is this subject to section 188A?

Answer

Yes. Section 188A does not apply to any loss incurred prior to the 1983/1984 income year. While development expenditure incurred prior to the 1983/1984 income year (but not deducted) has been incurred it cannot create a loss until the year in which it is claimed as a deduction. If it is claimed as a deduction in the 1983/1984 or future years, then s.188A applies.

Question 6

Is a "farmer" who enters into a sharemilking 50 percent agreement with a sharemilker who owns his own herd, an "existing farmer" for the purposes of this section?

Answer

A 50 percent sharemilking agreement is a private contract between the two parties and there is generally no standard form of agreement as there is for some lower percentage sharemilking agreements.

The normal position under such agreements is that the land owner retains management control of the land and is responsible for some or all of various types of expenditure, for example:

- Fertiliser and Lime
- Weed and Pest Control
- Repairs and Maintenance of Buildings, Fences, Plant, etc.
- Vehicle Maintenance
- Rates and Insurance

In this situation the land owner, due to his retention of management and partial financial control, is conducting (holding an interest in a specified activity in association with another person) the specified activity of a business of animal husbandry. Consequently, section 188A will apply in relation to both the sharemilker and the land owner.

Question 7

Can a specified activity that was, on 11 October 1982, operated at a loss be an "established activity"?

For example, in 1981 a taxpayer was operating a successful sheep farm in the central North Island and in December of that year he purchased 10 hectares in the Bay of Plenty for development as a kiwifruit farm.

Work undertaken on the "kiwifruit" land prior to 11 october 1982 included contouring and the planting of shelter trees.

Answer

The definition of an "established activity" firstly requires that on 11 October 1982 the taxpayer be an "existing farmer" (as defined) and secondly, that the specified activities operated by the taxpayer on 11 October 1982 constituted his livelihood and sole or principal source of income at that time.

The important point is that the definition requires that (for purposes of the definition) the Commissioner look at all the specified activities operated by the taxpayer and not each specified activity separately. In this case the sheep farm and the kiwifruit development together constituted the livelihood of the taxpayer and the sole or principal source of his income at 11 October 1982. The taxpayer would be able, therefore, to satisfy the tests of an "established activity".

Question 8

May a taxpayer delay claiming deductions by way of depreciation in order to adjust the level of profit/loss in any year so as to minimise the effects of the application of section 188A?

Answer

Any taxpayer may, in any income year, claim an amount of ordinary depreciation lower than the amount that would normally be allowed, and consequently claim depreciation on a higher figure in a later year. In this way the taxpayer may legitimately influence the level of profit/loss from a business activity from year to year. It is of no concern to the Department that such action may reduce the amount of loss incured in an income year and thus the amount of loss that falls to be contained under section 188A.

Note that first year depreciation allowances must be claimed in the year the asset is first used in the business, i.e., failure to claim the first year depreciation allowance in the year the asset is first used would result in that allowance being irretrievably forfeited.

Question 9

A number of questions have been raised in relation to the accounting problems in identifying expenditure for the purpose of quantifying the profit/loss which is fairly attributable to a specified activity.

What is this Department's policy on keeping records to separate the expenditure incurred in respect of each separate specified activity and any other business activity?

Answer

A taxpayer is required under section 428 of the Income Tax Act to maintain adequate records to enable his assessable income to be readily ascertained. It is implicit that a record be kept of the losses and costs, not only direct costs but also an allocation or apportionment of overhead or indirect costs, on the best or most appropriate basis to ensure each business bears its correct share of that cost.

It is desirable in cases of multi-purpose expenditure that a record be kept (for example, a log book to record tractor use) to enable an apportionment to be made. The apportionment basis for other expenditure may be a matter for determination in an appropriate case and can be discussed with the Department in cases of any doubt.

Question 10

Concern has been expressed that while the $10,000 limit does not apply to an existing farmer who conducts an established activity the effects of the definitions of "existing farmer" and "established activity" can cause anomalies because of their reference to the specified activity having to be the livelihood of the taxpayer and his sole or principal source of income.

Answer

The questions of "existing farmer" and "established activity" must be decided on the facts of each case. The important point is that the words "sole or principal", as they appear in the definitions, relate to the source of the taxpayer's income rather than to the outright quantum of income actually generated by any source during an income year.

It is clear from case law pertaining to comparable situations that in determining whether a taxpayer is an "existing farmer" in relation to a particular time or period of time, the question which must be asked is: Is the conduct of the specified activity (or the specified activities) at that time or throughout that period by and large the taxpayer's way of living, so that any reasonable person would say that that conduct was the primary and fundamental means by which the taxpayer strove at that time or throughout that period to make his living? In other words, what was the primary and fundamental means by which he strove to that end, as opposed to a merely incidental or accessory means?

Question 11 Is an amount paid to a Primary Producer Co-operative for storage of fruit in its cool store facilities expenditure incurred in conducting the specified activity of the business of growing trees or plants for the production of fruit?

Answer All expenditure incurred while the grower retains ownership of the produce together with any marketing expenditure incurred by the grower is expenditure incurred in conducting the specified activity and is an item of expenditure that is to be taken into account in calculating the amount (if any) of the loss that is subject to containment under section 188A.

Question 12 Are grape growing, and kiwifruit growing, specified activities of the same kind and thus "related activities" (as defined) for the purposes of section 188A?

Answer Grape growing constitutes the specified activity that is described in section 188A(1) as "the business of viticulture". This is in accordance with the dictionary, and long-understood, meaning of "viticulture".

Kiwifruit growing constitutes the specified activity that is described in section 188A(1) as "the business of growing trees or plants for the production of fruit (other than grapes)".

It follows that as grape growing and kiwifruit growing are specified activities that are not of the same kind (within the section 188A(1) definition of "specified activity") they cannot be "related activities" within the meaning of paragraph (a) of the definition of "related activity". In regard to paragraph (b) of the latter definition they are most unlikely to be complementary activities within the meaning of section 188A(3) (and thus would not be "related activities"), but they may be "related activities" pursuant to the 5 year land ownership test in section 188A(4).

(B) Section 188B - Transitional Provisions

Question 13 How is provisional tax to be calculated by taxpayers affected by the loss containment provisions (section 188A) and transitional tax-deferral measures (section 188B) inserted by section 32 of the 1982 Income Tax Amendment Act (No.2)?

Answer In terms of the new section 188B, the tax liability for a tax year may not be due and payable for up to 3 years after the terminal tax for that year would normally be due and payable. For this reason it would not be appropriate to calculate provisional tax in accordance with the normal section 379 provisions. Nor in this situation would it be possible for the taxpayer to make use of the provisions of section 387 to estimate his liability as these relate only to a taxpayer's estimation of his assessable income for the year and not to situations where deferrals of his actual tax liability are involved.

It has therefore been decided that where a taxpayer will be taking advantage of the transitional measures contained in the new section 188B of the Act he will be permitted (under section 383 of the Act) to base his provisional tax for that year on his estimated tax liability for that year after deducting the estimated amount of tax that he will be allowed to defer under section 188B. A taxpayer can estimate or subsequently re-estimate his provisional tax, using this method, up to the date his second instalment of provisional tax becomes due.

The taxpayer's request for a section 383 adjustment must, however, be accompanied by an estimate of his income from all sources and his losses from all sources, calculated on as factual a basis as possible.

In considering an application to adjust provisional tax for any year in accordance with section 383, consideration will be given to the accuracy of the information supplied by the taxpayer in respect of any similar application made for the previous year. If a previous substantial under-estimation of provisional tax has arisen because of inaccurate information supplied by the taxpayer the application in respect of the current year will be declined. The point is that the Department is simply not prepared to permit the use of this concession to defer payment of tax that is not entitled to be deferred under section 188B.

The following example illustrates the options for calculating provisional tax in appropriate cases.

YEAR ENDED 31 MARCH 1983

INFORMATION:

	$
Professional income	80,000
Specified Activity losses	(70,000)
Taxable Income	10,000

	$
Tax on Taxable income *	2,440
Less 1983 Provisional Tax paid (say)	2,400
Terminal Tax payable 7.3.84	40

	$
1984 Provisional tax Payable 7.9.83	813
7.3.84	1,627
	2,440

* All tax calculations are based on 1 October 1982 tax rate scale including tax surcharge.

YEAR ENDED 31 MARCH 1984

INFORMATION:

	$
Professional income	80,000
Specified activity losses	(70,000)

Actual tax position applying the provisions of section 188A:

	$
Professional income	80,000
Specified activity losses (maximum offset)	(10,000)
Taxable Income	70,000

	$
Tax on Taxable income	35,094
Less "Deferred Tax" #	32,654
	2,440
Less 1984 Provisional Tax paid	2,440
Terminal Tax Payable 7.3.85	Nil

#Tax Deferral Calculation

	$
Professional income	80,000
Specified activity losses	(70,000)
Actual Net Income	10,000

	$
Tax on actual net income	2,440
Tax on taxable income	35,094
Deferred Tax	32,654

Due dates for payment of 1984 deferred tax (together with interest)

	$
• 7 February 1986	10,884
• 7 February 1987	10,885
• 7 February 1988	10,885
	32,654

1985 Provisional Tax Options

(i) 1985 provisional tax would be payable in terms of section 379 based on the tax payable on 1984 taxable income - i.e., $35,094 in the example above.

(ii) The Department will accept an estimate of provisional tax in terms of section 383 provided it is based on an accurate estimate of assessable income and tax liability for that year. The following example illustrates the method of calculation:

INFORMATION:

	$
Estimated 1985 professional income	85,000
Estimated 1985 loss from specified activity	(45,000)

The offset of specified activity losses will be limited to $10,000 under section 188A.
Therefore:

	$
Tax on estimated taxable income ($75,000)	38,394
Less estimated deferred tax (in respect of $35,000 loss containment)	23,100
Estimated 1985 provisional tax	15,294

Note The amount of any tax deferred in previous years and becoming payable during the year is not added to the estimated provisional tax calculation for that year.

Question 14 How are salary and wage earners to be given the benefits of the transitional measures (contained in section 188B as inserted by section 32 of the Income Tax Amendment Act (No. 2) 1982)?

Answer A salary and wage earner is in a similar situation to a provisional taxpayer who wishes to re-estimate his provisional tax for the year, taking into account both the maximum loss which may be offset under the new section 188A and the transitional measure contained in the new section 188B of the Act.

A salary and wage earner engaged in a "specified activity" which is incurring a loss has two alternative courses of action:

(i) The first alternative is to select the appropriate primary or secondary tax code in respect of his salary and wage income and, at the end of the year, after filing his return of income, obtain a refund of PAYE tax deductions made in excess of the tax actually payable in respect of his taxable income for the year (after allowing for any deferral under the new section 188B).

(ii) The second alternative is to obtain a Special Tax Code that will take into account:

- The taxpayer's estimated salary and wage income.
- The taxpayer's estimated income from other sources.
- Losses incurred in "specified activities" up to the maximum level of offset allowed under section 188A.
- The amount of tax that may be deferred under section 188B.

Any application for a Special Tax Code should be supported by a high standard of information similar to that required to support an application by a taxpayer for a recalculation of provisional tax under section 383 (as discussed earlier).

Similarly, an application for a special tax code will be declined where the information provided by the taxpayer in support of an application for a Special Tax Code in the previous year has proved inaccurate.

Section 37 - Specified Leases (Sections 222A - 222E of principal Act)

Question 1 Does a guaranteed residual value have to be expressed in a dollar amount?

Answer No. The guaranteed residual value is a value agreed between the lessor and the lessee to be the value of the lease asset at the expiry of the lease term. It may be expressed as NIL, (i.e., no value) or by a method by which an amount may be determined, i.e., "fair market value".

Question 2 Production Based Lease Payments

Certain specified leases provide for a minimum rental and an additional rental based on the usage of the leased asset. In such cases the total sums payable under the lease vary from period to period and are not known until termination. How is the income of the lessor calculated in such cases?

Answer While the leasing provisions do not specifically mention the treatment for specified leases where the rental is contingent on the future production of the lease asset, the Department will determine the income from the lease on the following basis:

(a) Any lease payment in excess of the cost price (as defined) to the lessor is deemed to be interest under section 222C(1).

(b) If the minimum payments required (excluding any overage payments) exceed the cost price then that excess will be required to be returned as income under the terms of section 222C(2). The overage payments arising from production will be income of the lessor (interest income) derived when any such payment is due and payable.

(c) In any case where the minimum lease payments do not exceed the cost price they will be taken as being capital repayments, averaged over the lease term, and a similar approach will be applied to overage payments to repay the remaining capital content, e.g., four year

lease, minimum rentals $10,000 per annum, cost price $44,000. The Department will treat $11,000 per annum as being capital repayments and any remaining payments for the same period as being interest. The capital repayments will be spread evenly over all lease payments made during the lease term.

(d) The deduction to the lessee for interest paid will correspond to the income of the lessor in respect of any particular instalment and tax depreciation allowances will be allowable to the lessee.

Note The term "overage" relates to those payments over and above the minimum lease rentals payable under the lease.

Question 3 Hire Purchase Agreements

Are hire purchase agreements considered specified leases and, if so, what will the Department's future policy be?

Answer The taxation treatment of income arising from genuine hire purchase contracts will continue unaltered. The definition of "specified lease" would include a hire purchase contract and the new tax regime in respect of such leases will apply. Under the provisions of section 222C(2)(a)(ii) the Department will accept the interest income arising from a genuine hire purchase contract as being applied evenly over the instalments, viz., on a straightline basis. In addition, the Department will continue to accept the "trading profit" as emerging on a similar basis as the instalments become due and payable.

Question 4 Both the following transactions are deemed to be hire purchase transactions under the Hire Purchase and Credit Sales Stabilisation Regulations 1957.

A. Where a finance house lends money to the purchaser of an asset upon some form of security.

B. Where a finance house makes a loan subject to the security of an existing hire purchase agreement, i.e., the vendor sells the future income stream from the hire purchase contract and receives an immediate cash payment. The hire purchase repayments are then paid to the finance house.

Are such loans affected by the new legislation?

Answer The two examples above are considered to be loans by the finance house provided that, in example (B), the assignment is only for security and not absolutely.

Under a hire purchase contract the trading profits of the vendor and the intrest arising from the credit advanced are not receivable by the vendor until any particular instalment is due and payable. If the hire purchase contract is assigned absolutely to a finance house then the vendor has realised his trading profit and that income is derived at that time. The income of the finance house from the hire purchase contract continues to emerge as the instalments are due and payable.

However, when a hire purchase contract is "mortgaged" to a hire purchase company, the assignment to the finance house is merely as security to ensure the loan is repaid even though the terms of the loan may require the instalments to be paid directly to the finance house. The income of the finance house is the interest arising from the loan. The income of the vendor continues to emerge as instalments become due and payable, as should the purchaser wish to pay the contract off early the vendor is obliged to give a rebate for the interest content of instalments which were not due at the time he receives full payment for the goods.

Question 5 Overseas lessors

Is the deemed interest income subject to non-resident withholding tax?

Answer The income arising from a specified lease is deemed to be interest for the purposes of the Income Tax Act 1976. In general it would therefore be interest for the purposes of New Zealand Domestic Law in regard to the various Double Taxation Agreements between New Zealand and other countries. The payments will, therefore, be subject to non-resident withholding tax provided the terms of any particular Double Taxation Agreement do not deem the payments to be of a contrary nature. Any particular case must be examined on the facts and the appropriate Agreement involved.

Question 6 Expiry/Termination of Leases

On the expiry of leases, and in particular nil residual value leases, the lease asset does not always revert to the lessor nor is it purchased by the lessee. In some cases the asset remains in the possession of the lessee and no more payments take place, and in others the lease is renewed in perpetuity for a peppercorn rent.

Is the asset deemed to be sold by the lessee to the lessor for no consideration under section 222B(5) in the above situations?

Answer

Section 222B(5) applies to any specified lease (other than a lease terminated prior to the expiry of the lease term where section 222B(6) applies) on the expiry of the lease term. Where a lease is renewed in perpetuity for a nominal sum section 222A(2) applies and the Department would treat both leases as being one lease for income tax purposes.

If at the end of the lease term the asset remains in the possession of the lessee and the lessor does not wish to recover the asset, section 222B(5) would still apply. In this case, however, the Department would not allow any further depreciation allowances to the lessee in the nature of a "loss on sale" on the expiry of the lease term as the lessee has not suffered any loss due to fair wear and tear or obsolescence (s.108) and has continuing and unrestricted use of the lease asset. Depreciation allowances at tax rates, based on tax book value at the expiry of the lease, would be allowed to the lessee in subsequent years provided the asset is used in the production of income.

Question 7 Motor Car Leases

Why will the Department not accept the rule of 78 for calculating interest deductible under motor car leases?

Answer

The rule of 78 method is not appropriate for motor car leases as the interest calculation is substantially different from that arising from use of the actuarial method.

The Department will accept interest income arising in a motor car lease to be returned on a straightline basis for income tax purposes under the provisions of section 222C(2)(a)(ii).

Question 8

When the lessor acquires the lease asset at the end of the lease term, can he claim first year depreciation allowances?

Answer

The lessor may claim first year depreciation allowances provided:

(a) The asset is used by him in his own business (the allowance will be claimable in the year in which it is first used by him).

(b) The allowances are based on the value of the asset on the expiry of the lease term as determined by section 222B.

Note The lease of the asset in the first place was, for the purposes of the Tax Act, a sale to the lessee. It follows that the leasing of the asset does not constitute use of the asset in the production of the lessor's assessable income.

Question 9 Does section 222E apply to bailments of livestock and leases of bloodstock?

Answer No. The definition of lease asset excludes livestock and bloodstock for the purposes of section 222E.

Section 41 - Business Records (Section 428 of the principal Act)

Question 1 What is the application date for the new section and what is its relationship to records retained under the previous section?

Answer The rewritten section applies with effect from the income (or accounting) year commencing 1 April 1983. Until 31 March this year a taxpayer was required to keep records for a period of 7 years under the previous provisions of section 428. From 1 April the new section applied, requiring records to be kept for 10 years from the end of the year to which they relate. Where more than 7 years' records were available on the first day of the income year commencing 1 April 1983 these must be retained in accordance with the new 10 year provisions. Where on the first day of the income year commencing 1 April 1983 only 7 years' records were available (in accordance with the old provisions) there will be a 3 year build up as firstly 8, then 9 and finally 10 years' records become available.

Question 2 What situation is envisaged by the proviso to subsection (3) of the amended section 428, which authorises the Commissioner to allow records to be kept outside New Zealand or to be kept in a language other than English?

Answer This proviso is intended to provide an element of flexibility where the major accounting functions of the business are carried on outside New Zealand. In such cases it would be impractical to require dual record keeping both in New Zealand and abroad.

Question 3 Why have we extended the period from 7 to 10 years?

Answer Investigations of taxpayers where fraud is suspected are usually investigated for a minimum of 10 years. Similarly a number of the tax provisions such as recovery of interest and land subdivisions have 10 year rules.

Question 4 What publicity are we giving to the need to retain records and the changes made?

Answer A PIB is being prepared and this will be sent to all employers.

Question 5 The change applies to the keeping of records in the income year commencing on 1 April 1983. Can a person destroy business records which are more than 7 years old in the period up until 31 March 1983?

Answer (a) Yes.