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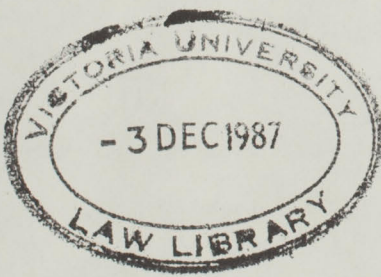
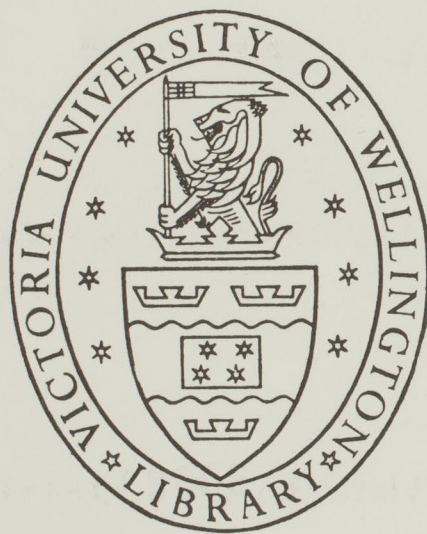
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INTRODUCTION

The Minister of Finance, the Hon. R.O. Douglas, announced in the 1986 Budget the intention of the Government to remove the problems of timing of income recognition and tax deduction. The proposed changes to the **Income Tax Act** 1976, seen as an important move against tax avoidance impacting primarily on businesses, especially large companies which had benefited most from deficiencies in the matching of income and expenditure in the previous law.

The early deductibility of expenditure and the late recognition of income separately or in combination gave taxpayers substantial opportunities to defer tax. Businesses had been able to reduce tax liability by deferring income and advancing deductions for income tax purposes. Few individual taxpayers were affected by the proposed reform.

The application of accrual rules to expenditure and income for tax purposes on a consistent basis meant that a closer matching of the timing of deductions and income recognition was achieved. Matching of income and expenditure on a cash basis left some scope for tax deferral arrangements between taxpayers and non-taxpaying bodies or taxpayers on different tax rates.

The Labour Government initiated a consultative process which outlined the nature of the proposed reforms. The **Consultative Document on Accrual Tax Treatment of Income and Expenditure** was released in October 1986 by the committee appointed by the

Government to receive submissions on matters affecting the implementation and efficient operation of the tax treatment concerning:

- (i) the time at which returns on debt instruments must be recognised for income tax purposes, and
- (ii) the time at which specified categories of expenditure are deductible for income tax purposes.

The **Income Tax Amendment Bill (No. 2)** was introduced by the Minister of Finance, the Hon. R.O. Douglas on 18 December 1986, in response to the concern expressed by the business community to the committee that there had been undue delay in bringing legislation before Parliament. The failure to provide clear legislative guidelines had encouraged uncertainty in commercial dealings.

The bill before Parliament had two advantages: it provided some guidelines as to the scope of the legislation, and allowed interested parties the time to make further comment when the Bill was referred to a Select Committee of Parliament before it was enacted. The revised bill came before the House on 18 March 1987 and the **Income Tax Amendment Act 1987** was passed by Parliament on 25 March 1987.

The **Income Tax Amendment Act (No. 2) 1987** was enacted on 22 July 1987 which made several changes of a drafting nature to accrual rules and clarified excepted financial arrangements.

This paper attempts to discuss the broader principles of income measurement and analyse the content and effect of the accrual rules on income tax law in New Zealand.

The theme of this paper is that the complexity of the statutory provisions for accrual rules has ensured that the implementation and operation of the rules will be expensive and difficult. The problems of deferral of income and expenditure in complex financial transactions are understood but it is likely that unwieldy and difficult taxing provisions will pose some practical limitations as financial schemes become more ingenious.

THE CONCEPT OF RECEIPT AND PAYMENT

The paper will be divided into four sections:

First, cash basis accounting, the accruals method, and the concepts of receipt and payment,

Second, realisation and recognition of income prior to the introduction of the accruals method,

Third, the **Income Tax Amendment Act** 1987 with particular emphasis on the implementation dates, definition of financial arrangements, yield to maturity method and the exceptions to that method, base price and post facts arrangements, determinations by the Commissioner and,

Fourth, the effect of the accruals rules on key taxing sections in the **Income Tax Act** 1976.

We will now consider each of these sections in turn, using the format of a general heading followed by subdivision into related topics.

CHAPTER 1

CASH BASIS ACCOUNTING, THE ACCRUALS METHOD AND THE CONCEPT OF RECEIPT AND PAYMENT

The **Income Tax Amendment Act** 1987 refers in Section 2, to the amendment of the principal act by inserting in the principal Act after Section 64A a new subheading which is **Accrual Treatment of Income and Expenditure Relating to Financial Arrangements**.

The Act in Section 64D provides that certain natural persons shall be cash basis holders if the income derived by that person in respect of financial arrangements does not exceed \$50,000 or the total value of financial arrangements does not exceed \$400,000. Section 64D(1)(b) provides that if the difference between the income that would be calculated by the natural person using the accruals method for financial arrangements specified in the Act and the income calculated for an income year if the person were a cash basis holder does not exceed \$15,000 the person shall be a cash basis holder.

Fundamental to the application of the Act is an understanding of the cash method and the accruals method of accounting. The principles of income measurement require some attention.

The term accruals or cash basis are not defined in the Act but there are a number of dicta exploring the concepts. It is proposed in this section to unravel the intricacies of methods

of accounting and clarify the key concepts underlying the Act. The use of the Crown for the year commencing on the 1st day of April in each year, a tax herein referred to as

We will begin with a discussion of the principles of income measurement.

(2) Subject to this Act, income tax shall be payable by every person on all income arising in the year for which the tax is payable

Income Measurement

A discussion of the accruals rules requires an understanding of the general principles of income measurement and the scheme of the **Income Tax Act 1976** which imposes certain requirements on financial reporting. This section of the paper looks at the relationship between accounting practices and principles with income tax legislation by examining particular aspects of taxation law, which are:

first, the annual taxing requirement of Sections 38 and 39

second, a legal description of profit and its measurement for income tax purposes, and

third, the statutory provision for deducting bad debts where the legislature has indicated an accruals method of accounting.

(1) An Annual Taxing Requirement

Income measurement presents some difficulties resulting from the convention of annual financial statements for external reporting and tax purposes, a rule established for administrative convenience. The **Income Tax Act 1976** established the principles of income tax collection in Sections 38 and 39. Section 38 imposes income tax and provides the following:

- (1) Subject to this Act there shall be levied and paid for the use of the Crown for the year commencing on the 1st day of April in each year, a tax herein referred to as income tax
- (2) Subject to this Act, income tax shall be payable by every person on all income derived by him during the year for which the tax is payable
- (3) The year in which income is so derived is in this Act referred to as the income year, and the year for which income tax is payable is in this Act referred to as the year of assessment.

It follows from the provisions of Section 38(2) that the **Income Tax Act** 1976 imposes a system of annual taxation. In *Commissioner of Inland Revenue v. Lemmington Holdings Ltd*,⁽¹⁾ the Court of Appeal said:

Income tax is an annual tax. The **Income Tax (Annual) Act** fixes the rate of income tax for the particular year only and the administration of the legislation follows an annual cycle.

Net income can be determined accurately only from the beginning to the end of the life of a business. The selection of a definite period of time means that income determination must be a matter of estimating the net income.

The imposition of an annual method of tax collection and the measurement of income annually is arbitrary, based upon the requirement of the Government for revenue and the need for the business community to receive financial information. By reason of being arbitrary, it must always be an imperfect system.

(2) Business profit for income tax purposes

The most fundamental question is what is profit. Profit is net income as expressed by Lord Herschell in *Russell v. Town and Country Bank* (2) when he stated that:

the profit of a trade or business is the surplus by which the receipts from the trade or business exceed the expenditure necessary for the purpose of earning these receipts. That seems to me to be the meaning of the word "profits" in relation to any trade or business unless and until you have ascertained that there is such a balance, nothing exists to which the name "profits" can properly be applied.

The general rule is that profit is measured according to the ordinary principles of commercial accounting as long as they are consistent with income tax legislation.

In the United Kingdom this rule has been expressed in various ways. In *Whimster and Co v Commissioners of Inland Revenue* (3) heard by the House of Lords, Lord Clyde said:

The account of profit and loss to be made up for the purpose of ascertaining that difference must be framed consistently with the ordinary principles of commercial accounting, so far as applicable, and in conformity with the rules of the **Income Tax Act ...**

Viscount Simmonds reiterated much the same statement in *Ostime v. Duple Motor Bodies Ltd* (4) when he stated that:

... first ... the ordinary principles of commercial accounting must as far as practicable, be observed and secondly ... the law relating to income tax must not be violated ... that is to say by one means or another the full amount of the profits or gains of the trade must be determined.

The role of the courts when determining what accounting principles will be used to elucidate profit was not clear. The accounting principles can be regarded by the court as a matter of fact to be determined according to the evidence, thereby determining the tax issue as long as there is no conflict with the taxing statute, a view which was adopted in ***Odeon Associated Theatres v. Jones*** (5) by Salmon L.J. who said:

Where, however, there is evidence which is accepted by the court as establishing a sound commercial accounting practice conflicting with no Act, that is normally the end of the matter. The court adopts the practice, applies it and decides the case accordingly.

The alternative view is that the question of the profit of the business is a question of law. The court must determine what accounting practice is most appropriate in any given situation.

Pennychuick V.C. in the Court of Appeal in ***Odeon Picture Theatres*** summarised this approach:

The concern of the court in this connection is to ascertain the true profit of the taxpayer ... In so ascertaining the true profit of a trade the court applies the correct principles of the prevailing system of commercial accountancy. I use the word "correct" deliberately. In order to ascertain what are the correct principles, it has

recourse to the evidence of accountants ... That is a question of pure fact but the court itself has to make a final decision as to whether that practice corresponds to the correct principles of commercial accountancy. No doubt in the vast proportion of cases the court will agree with the accountants but it will not necessarily do so. Again there may be a divergence of view between the accountants, or there may be alternative principles, none of which can be said to be incorrect, or of course, there may be no accountancy evidence at all. The cases illustrate these various points. At the end of the day the court must determine what is the correct principle of commercial accountancy to be applied.(6)

Accounting principles and practices must be responsive to the accrual rules contained in the legislation, which has meant that financial accounting methods are much more in line with accounting for tax purposes.

The computation of income for tax purposes is not the same as for financial accounting purposes. It is for the court to declare what is assessable income and business profit. As we have seen these are questions of law for a court to determine. The court may accept or reject certain accounting principles and practices used in arriving at assessable income. A taxpayer's income from a business is made assessable income by virtue of Section 65(2)(a) which provides that business profits include:

All profits or gains derived from any business (including any increase in the value of stock in hand) at the time of the transfer or sale of the business, or on the reconstruction of the company.

Inherent in the concept of a business is that it has the objective of achieving a pecuniary profit. An intention to make a profit is sufficient even though it is unlikely that the goal will

be attained. The pecuniary profit which the taxpayer must intend achieving is a profit in money or money's worth as ascertained in ordinary commercial principles which affect the type of undertaking to be considered. Only a totally unrealistic venture can be excluded on the test propounded in *Grieve v. Commissioner of Inland Revenue* (7) on the grounds that no reasonable person could have expected to make a pecuniary profit as the activity was conducted in such a way that failure was inevitable.

(3) The statutory provision for deducting bad debts

It is for the courts to declare what accounting method should be adopted in situations where there is a dispute between the method imposed by the Commissioner and the taxpayer. As a general practice, the Commissioner requires that all taxpayers carrying on a trade or profession adopt the accruals method of tax accounting. Other taxpayers including wage and salary earners and doctors and barristers are able to adopt the cash method of accounting. The Commissioner's ruling is a matter of policy only, but the Court of Appeal in New Zealand has concurred with the Commissioner's general ruling by declaring on several occasions that the accruals method applies to most taxpayers who carry on a business but there was once nothing in the **Income Tax Act 1976** which required that a cash or accruals approach must be necessarily adopted in any given situation. Section 106(1)(b) legislated for bad debts and provided that bad debts can be an allowable deduction as long as certain conditions were met including an accruals method of accounting. Section 106(1)(b) provides:

Bad debts, except debts which are proved to the satisfaction of the Commissioner to have been actually written off as bad debts by the taxpayer in the income year.

Provided that all amounts at any time received on account of any such bad debts shall be credited as income in the year in which they are received and shall be subject to tax accordingly.

Barristers, medical practitioners and other taxpayers who calculate their tax liability on a cash basis are not able to take advantage of this provision. The taxpayer has not received the money in question and cannot bring it into account for tax purposes. The accruals system of tax accounting applies only to businesses. In ***Commissioner of Taxes v. Executor Justice and Agency Co of South Australia***(8) Dixon J. expressed the effect of a similar enactment in Australia in the following way:

The foundation of the accrual system is the view that accounts should show at once the liabilities incurred and the revenue earned, independently of the date when payment is made or becomes due. It plainly is not applicable to every pursuit by which income is earned. [The Act] does not appear to me to intend to fix it upon every business or vocation which involves the giving of credit. But it does contemplate the application of the system, whether with severe consistency or in modified form, to many if not most undertakings and enterprises and for that reason directs specifically what deduction on account of bad and doubtful debts will be allowed.

The provision for bad debts was thus somewhat anomalous with deduction for income bad debts available under Section 106(1)(b) if the accounts are kept on an accruals basis. The legislation of 1987 retains that distinction but dealers in financial arrangements can claim a deduction for bad debts of both income and capital.

The Cash Method of Accounting and the Accruals Method

The oldest and simplest method of accounting is the cash receipts and disbursements method. By the cash method of accounting, transactions are recognised only when cash or property is actually received or paid. In most business situations this method cannot provide an accurate picture of the business at any one time. Any business with a large inventory and accounts receivable must use an accrual method of accounting. The accruals method requires that transactions that give rise to revenue or costs are recognised in the accounts when the cost is incurred or the revenue is received.

Viscount Simmonds in *Whitworth Park Coal Co Ltd v. Inland Revenue Commissioner* (9) made the classic statement on the difference between the cash and the accruals method of accounting. He pointed out that ordinary individuals who do not have a trade or profession have no need for a profit and loss account. The ordinary individual is in a different position from a trade because:

Sums paid to him are his income, and it would be a great hardship to require him to pay tax on sums owing to him of which he cannot yet obtain payment.

On the other hand a trader's situation is more complex. A true picture of the business requires some notice of trading debts.

... in computing a trade's income, accounting must be taken of trading debts which have not yet been received by the trader. The price of goods sold or services rendered is included in the year's profit and loss account although that price has not yet been paid. One reason may be that the price has already been earned and that it would give a false picture to put the cost of producing the goods or rendering

the service into his accounts as an outgoing but to put nothing against that until the price has been paid.

Taxpayers using the cash method for income tax purposes generally report revenue items in the year in which they are actually received. Expenditure is taken into account only when it is actually paid. The cash method does not present an accurate picture of the income earned and the expenses incurred to earn that income, as it is usual in business that there be a time lag between the earning of income and the receipt of income. The cash method may be used by a taxpayer in receipt of a single sum of an income-nature, who does not carry stock-in-trade, does not carry on a business, and has expenditure that does not correspond with, nor contribute materially to, the way it is earned.

The cash method is used by wage and salary earners, doctors and barristers. The assessable income is the difference between the cash amounts actually received during the income year, and the expenses actually met during the same period. Any fees earned but not yet received are not included.

The use of the cash basis may not be always appropriate. The considerations governing its use:

are to be found in the nature of the profession concerned and indeed the actual mode in which it is practised in a given case. Where there is nothing analogous to a stock of vendible articles to be acquired or produced and earned by the taxpayer, where outstandings on the expenditure side do not correspond to, and are not naturally connected with, the outstandings on the earnings side, and where there is no fund of circulating capital from which income or profit must be detached for actual enjoyment, but where on the contrary, the receipts represent in substance a

reward for professional skill and personal work to which the expenditure on the other side of the account contributes only in a subsidiary or minor degree, then I think according to ordinary conceptions the receipts basis forms a fair and appropriate foundation for estimating professional income.(10)

A general rule about which method is the most suitable cannot be laid down. This will depend upon the particular circumstances.

If in a given medical practice there is but little certainty about the payment of fees, I should have thought that a receipts basis of accounting would alone reflect truly the income and for most professional incomes it is the more appropriate. But to a greater degree the question of whether income of a particular kind can be properly calculated on one basis alone or upon either, must depend on the nature of the source of the income.(11)

Cash basis accounting may also be the correct approach in certain other circumstances as in *Brent v. FTC*.(12) A housewife with no other income from a business or profession was paid a sum of money for interviews with her about her eye with a notorious criminal. The total amount of the payments were due and payable in the relevant income year but she had received only one instalment in that year. Gibbs J. gave his decision as follows:

In the present case the taxpayer did not carry on a business or profession. She had no stock in trade. Her expenditure did not correspond with or materially contribute to her earnings. What she received, and was entitled to receive, was a reward for personal services. If the whole of the amount receivable was treated as income in the year in question, and part of that debt proved bad, there was not likely to be any income in a future taxation year against which the bad debt could be written off.

There is no commercial practice or principle of accountancy, that requires the whole of the amount due to the appellant in a case such as the present to be brought into account for the year in which it was earned. In all the circumstances of the case it seems to me that the true income derived by the appellant was the amount that she actually received in the year in question.

The courts in New Zealand have consistently applied the principle that the accruals method is the most appropriate means of determining assessable income for business.

In *Fincon Construction v. Commissioner of Inland Revenue* (13) the Court of Appeal applied that principle. To use any other method would distant the company's trading operations. The case concerned a building company being entitled to deduct as expenditure the whole of the costs of the material and labour involved in the erection of the motel units but claiming only part of the contract price for the building of the motel units as profit. The court did not agree with the approach taken, North P. reasoning that:

... we would be creating a precedent which would run counter to established commercial practice and would create many difficulties.

The President then went on to say:

Having regard to the general nature of its business, I do not consider that the applicant is entitled to single out one particular transaction and ask that it be dealt with in a special way for it is plain that if the contention of the appellant is upheld, the profit and loss account of the appellant for the year in question would give a wholly false picture of its trading operations for the year in question.

The court is concerned with obtaining an accurate portrayal of the assessable income of the business in question.

The taxpayer must adopt the method of tax accounting which best discloses the true income of the taxpayer. Accordingly, it is not for the taxpayer to determine what is in his or her view the best method of tax accounting. The courts will determine whether or not a method accurately portrays the assessable income of a business.

This approach in New Zealand was confirmed in *Commissioner of Inland Revenue v. National Bank of New Zealand* (14) when the court held that it was not for the taxpayer to select the method of tax accounting to be adopted. Richardson J. states unequivocally that a trading corporation cannot justify a method of accounting because from a commercial and accounting point of view it was most suitable for its own corporate purposes. He said:

The system must not only be fair to the taxpayer but also fair to the revenue. When the Commissioner of Inland Revenue puts forward a system which he contends should be adopted for tax purposes, then the court has to decide whether the Commissioner's system will or will not be better calculated to produce a more accurate picture of the actual profits in each income year than will the system adopted by the taxpayer.

The accruals method of accounting recognises revenue when it is realised. Expenses are reported in the same time period as the revenues incurred. In other words, the accruals method attempts to achieve a closer match between income and expenditure so that business transactions are more accurately reported.

In *Commissioner of Inland Revenue v. Farmers Trading Company* (15) consumer goods sold on credit had to be accounted for using the accruals method. Richardson J. in that case observed that he was:

... satisfied that the scheme of the New Zealand income tax legislation and the legal principles enunciated in the cases which I have been discussing established that where a trader sells stock on commercial credit as in this case and where the earning process is thus complete, their resulting debt must be reflected in the profits derived from the business in the year of sale if it is practicable to do so.

The practical difficulty of the accruals method is the selection of the time at which income may be said to be realised, and therefore recognised as being earned in a particular fiscal period.

The method is imperfect mostly because it may require taxpayers to return and pay tax on sums which have not yet been received which can cause cash flow problems for the taxpayer. Any accounting method must contain some element of artificiality so that the true profit and loss of a business for any period cannot be accurately quantified. Richardson J. alludes to the difficulty of presenting accurate accounts when discussing differences in the objectives of tax accounting and accounting for financial reporting purposes in the *Farmers Trading Company Limited* case.

An income tax system is concerned only with the measurement of income whereas accounting principles and practice are directed towards producing financial statements of a business which fairly present the financial position at a point in time as well as the results of operations for the accounting period ending at that time.

The disparity between accounting practice for financial reporting and the measurement of income for taxation purposes is evident with debt instruments. Normal accounting practice uses the accrual method so that income and expenditure are spread over the term of the loan, whereas previous tax rules allowed tax deductions for expenditure to be brought forward and assessability of income to be deferred, with the result that the taxable income of a business may be quite different from the income it reports to its owners.

- (5) [1972] 1 ALLER 681 @ 689
- (6) [1971] 2 ALLER 407 @ 414
- (7) (1983) 6 NZTC 61,682
- (8) (1938) 1 AITR 416 @ 444 per Dixon J
- (9) [1959] 3 ALLER 703 @ 713
- (10) *Commissioner of Taxes v. Executor Trustee and Agency Co of South Australia* (1938) 1 AITR 416, 442 per Dixon J
- (11) *Ibid.* @ 446 per Dixon J
- (12) (1971) 2 ATR 583, 570
- (13) [1970] NZLR 462
- (14) (1976) 2 NZTC 61, 150
- (15) (1981-82) 5 NZTC 61, 200 @ 61, 204

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- (1) (1982) 5 NZTC 61,268
- (2) (1888) 13 ATC 418 @ 424
- (3) (1925) 12 TC 813 @ 823
- (4) [1961] 2 ALLER 167 @ 169
- (5) [1972] 1 ALLER 681 @ 689
- (6) [1971] 2 ALLER 407 @ 414
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- (8) (1938) 1 AITR 416 @ 444 per Dixon J
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- (10) **Commissioner of Taxes v. Executor Trustee and Agency Co of South Australia** (1938) 1 AITR 416, 442 per Dixon J
- (11) Ibid. @ 446 per Dixon J
- (12) (1971) 2 ATR 563, 570
- (13) [1970] NZLR 462
- (14) (1976) 2 NZTC 61, 150
- (15) (1981-82) 5 NZTC 61, 200 @ 61, 204

CHAPTER 2

THE FORMER TESTS FOR THE TIMING OF TAX DEDUCTIONS AND INCOME RECOGNITION

PROBLEMS OF TAX DEFERRAL

The deduction of expenditure and the recognition of income under previous statutory tests was not symmetrical. Expenditure was deductible under the **Income Tax Act 1976** prior to the accruals amendment, when it was incurred. Expenditure could have been incurred and thereby be deductible without it being paid. Expenditure could have been deducted even when it related to later income years. On the other hand, the assessability of income could be deferred. Income was not taxable until it was received or receivable.

The basic financial concept of the time value of money is that all deferred payment transactions include some interest, whether actual or implied. The accruals rules bring the tax legislation into closer alignment with accounting practice and economic concepts of income by providing a framework for determining the timing of recognition of income and expenditure in relation to financial arrangements.

Accounting for revenue and expenditure on a consistent and comprehensive accruals basis would succeed in removing the scope of tax deferral and prevent erosion of the revenue base so that other taxpayers make up the shortfall in tax.

The mismatching of deductions for expenditure and assessability of income allowed opportunities for tax avoidance and tax planning to minimise the incidence of taxation. Early deduction of expenditure, in particular interest expenditure by the business community, and deferral of interest income had resulted in considerable revenue loss to the government. The Minister of Finance, the Hon. R.O. Douglas explained that:

These deficiencies were widely exploited and caused a considerable revenue loss for government. The new rules close the loopholes and significantly improve the fairness of the tax system.(1)

Inequitable distribution of taxation was the result with the majority of taxpayers not being in a position to exploit the tax advantages gained by corporations conducting large financial transactions. It was accepted by the government that the taxable income of a business, nor company may have little resemblance to the income that it reported to its owners or shareholders. The result was that the integrity of the taxation structure was undermined.

Financial transactions were able to take greatest advantage of the outdated rules affecting income recognition and deduction of expenditure. A heightened awareness of the importance of interest and the time value of money characterised the financial markets. The principal features of the new approach to tax practice and financial transactions were first, international interest rates were consistently high during the late 1970s and early 1980s and they remained high when compared with historical rates, secondly, evidence of increasing use of tax havens which inevitably distorted revenue collection.

The innovativeness of the financial markets, the liquidity of financial investments and the ability to restructure transactions were some of the reasons that made the law as it was,

inequitable. The financial markets were able to take advantage of international economic trends to make tax free profits.

In large transactions, small differences in the tax treatment of financial instruments could be crucial and produce considerable benefit to the holders. Taxation policies in the United States, Canada, the United Kingdom and Australia recognised that timing problems of income measurement had led to a major revenue loss and accordingly enacted accrual rules for tax purposes.

The **Consultative Document on Accrual Tax Treatment** identified particular situations which allowed loopholes in the legislation to be used for tax avoidance. The consultative document was in no doubt that use of these transactions had meant that in extreme situations payment of tax could be voluntary for some businesses.

Income tax legislation under the old regime had not yet caught up with the realities of the financial markets and the economic theory.

Economic theory refers to deferred payment transactions and advance payment transactions. The term deferred payment transaction refers to a transaction in which one party gives consideration immediately and the other party can pay for it later. The most common examples of deferred payment transactions are a loan, where the borrower receives money now and pays the money back later. An interest or interest equivalent must always be present in any deferred payment transaction. The principle in any contract when parties perform the contract at different times is that a portion of the value given by the later performance is compensation for the privilege of performance being delayed. Clearly the money or services available immediately is more valuable than the same money or services available at a later date. The following are examples in two cases of

deferred payment transactions and one advance rental payment of advance payment transactions. Conceptually there is no difference between the two concepts.

(2) Zero Coupon Bond

The three examples illustrate how an absence of symmetry between deduction of expenditure and receipt of income can produce taxation advantages. They also reveal how differences between accounting practice and requirements for taxation purposes, produced anomalous results.

(1) Twelve-Month Payment of Interest in Arrears

Say A and B taxpayers both have 31 December balance dates. Taxpayer A (the lender) agrees to lend to B taxpayer (the borrower) the sum of \$1 million dollars for one year with interest payable in arrears on 30 June at a rate of 10 percent. By accepted accounting principles it is usual for A, the lender, to spread the interest income over the term of the loan. B, the borrower, would also proportion the interest expense over the period of the loan so that about half of the interest income and expenditure would be recorded by each of the respective parties over a period of two accounting years.

Previous tax rules would not require A to pay any tax on interest income until the second accounting year as only then would the interest become receivable and therefore taxable. Interest expenditure would usually be claimed by B over the two year accounting period, although it is possible that the whole amount of interest expenditure could be claimed in the first year of the loan entitling B to a full deduction.

The example shows how accounting practice and taxation rules differed so that there was a mismatch of income and expenditure for taxation purposes.

(2) Zero Coupon Bond

A zero coupon bond is a debt instrument which requires no instalments of interest. The investment return consists of the excess that is paid by the borrower for redeeming the bond when it matures. The borrower redeems the bond for a higher price than that at which it was issued and the difference between the issue price and the redemption value (the discount) is the interest income of the lender and the interest expenditure of the borrower.

For accounting purposes the redemption payment would be spread by the lender over the accounting periods over which the bond was issued. Similarly the borrower would recognise expenditure proportionally over the whole of the accounting period that the bond has currency. In contrast, taxation legislation prior to the enactment of accrual rules, ensured that the lender would be taxed when the income from the bond became receivable thereby deferring the payment of taxation on income. Theoretically the borrower could choose to treat the expenditure on the bond in one of two ways, for tax purposes. The borrower could apportion the expense over the whole period that the bond is in existence, in keeping with accounting practice or attempt to deduct the whole of the deduction for the redemption payment in the year in which the bond was issued. The Commissioner had not accepted that either of these two methods of deducting expenditure was correct. In the view of the Commissioner the discount expense was not incurred and could not be deductible until the redemption payment fell due.

There are complex issues relating to the timing of interest deductions for zero-related bonds, and considerable potential existed for deferring of interest income by the lender

and interest expense by the borrower.

(3) Three Year Rental Prepayment

This example is simpler than the previous two but again it illustrates how advantage could be taken of the mismatch of income and expenditure under the legislation prior to the 1987 amendment.

X and Y have 31 December balance dates. X rents a property to Y for three years from 1 July 1985 to 30 June 1988. Y pays the total rent of \$360,000 in advance.

Following standard accounting practice, the rental income and expense would usually be spread over the three year term of lease, so that the rental expense would be deducted at a constant rate of \$10,000 per month.

The former tax rules would entitle Y to deduct the rental prepayment in full when the expenditure was incurred on 1 July 1985. X would generally be required to record the rental income as it accrues over the term of the lease at the rate of \$10,000 per month. Deductible expenditure has been advanced, in this example, allowing the opportunity to defer tax.

The former tax regime did allow taxpayers to exploit the rules and give unlimited scope to avoid payment of tax by the use of offsetting loans.

It is beyond the scope of this paper to discuss the many ways in which ingenious schemes were devised to take advantage in the shortcomings of the taxation legislation prior to the

1987 amendment but a general picture will suffice. We will now consider two extreme illustrations of tax avoidance schemes which were legitimate business practice.

Offsetting Loans Used to Cancel Tax Liabilities

The arrangement relies on a series of lending arrangements between two taxpayers so that each party incurs interest expenditure without actually receiving any interest in that income year.

Say two taxpayers who receive interest income on a receivable basis each expect to have incomes of \$1 million from interest for the accounting year ending 31 December 1986. The taxpayers are able to avoid paying tax on the anticipated income by agreeing to lend each other \$5 million on 1 January 1986 on which 20 percent interest is payable on 1 January 1987. By the terms of the law prior to the 1987 Amendment both taxpayers would have incurred interest expenditure of \$1 million in 1986. There would be no accounting for interest income in 1986, as the interest was not receivable in that year. However the taxpayers could be liable to pay tax on assessable income of \$2 million in 1987 if their expected interest income of \$1 million continued as in 1986. To ensure that taxation on the interest income received need not be paid the taxpayers would enter another contract on 1 January 1987 when they would lend each other \$10 million on which \$2 million of interest was payable on 1 January 1988, thereby perpetuating the process indefinitely.

Agreements Between Taxpayers on Different Tax Rates, Non Taxpayers and Non-Residents

Opportunity for tax avoidance schemes occurred between a taxpayer and a non-taxpayer or two taxpayers on different tax rates. Superannuation funds, primary producer and marketing boards and local authorities are exempt from tax. There is also ample opportunity for financial flows between taxpayers in New Zealand and entities resident overseas including tax havens.

A non-taxpayer (a superannuation fund or a company resident in a tax haven) could have lent a high-rate taxpayer a large amount with the interest being included in the loan. The high-rate taxpayer agrees to lend back to the non-taxpayer the same amount minus the interest prepayment. The high-rate taxpayer would have been able to deduct all of the interest expense in the first year of the loan because it had been prepaid. The taxpayer would not have been taxed on the interest income received from the lend-back arrangement until it was actually received. Accordingly, the taxpayer received the benefit of deferral of tax for the loan period. Two domestic taxpayers on the same rate would not have received any advantage from this arrangement.

A cash basis of accounting would not succeed in removing taxation advantages for arrangements of this sort for income would be assessable and expenditure deductible only when payments were made. The accruals system means that income and expenditure are spread over the term of the loan. Under the example given the taxpayer would benefit from the deferral of tax on the amount of the loan. Tax deferral was a legitimate means of minimising the incidence of taxation. The cash basis could not remove the benefit of a tax deferral scheme between non-taxpayers, taxpayers on different tax rates and non-

residents. Accrual rules now mean that this problem has been removed as it would ensure that the taxpayer's liability could not be deferred.

(1) *Press statement April 1987 in Report of the Consultative Committee on Accrual*

Previous income tax provisions had not kept pace with the innovative financial schemes which took advantage of the asymmetrical accounting of income and expenditure.

REFERENCES

- (1) Press statement April 1987 in ***Report of the Consultative Committee on Accrual Tax Treatment of Income and Expenditure***

**PREVIOUS RULES GOVERNING THE TAKING OF
TAX DEDUCTIONS AND THE FROGGETION OF INCOME**

It is not possible to understand fully the impact of the accrual rules without an appreciation of the general legislative scheme of income tax legislation in New Zealand. The change to accrual rules on a comprehensive basis is a change of a fundamental nature which has meant a new approach to primary taxing provisions. More complex legislation is an inevitable result with a taxation structure which is struggling to keep up with more sophisticated and complex financial dealings. The new international outlook of New Zealand's financial markets and a deregulated economy has meant the opportunity to exploit previous deficiencies in income tax legislation exists on a wider scale than it did even ten years ago. It is proposed to examine the previous statutory requirements in order to show why legislation to remedy the mischief was necessary.

Assessable Income

Assessable income is widely defined in Section 55 of the Income Tax Act 1976. If the list is not exhaustive enough the section concludes with:

Income derived from any other source whatever.(1)

CHAPTER 3

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Assessable Income

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Income derived from any other source whatever.(1)

To be read closely with Section 65 is Section 101 which limits allowable deductions in calculating assessable income to those which are expressly provided in the Act. Section 104 is the primary taxing provision of the Act and provides that:

In calculating the assessable income of any taxpayer, any expenditure or loss to the extent to which it -

- (a) Is incurred in gaining or producing the assessable income for any income year or
- (b) Is necessarily incurred in carrying on a business for the purpose of gaining or producing the assessable income for any income year

may except as otherwise provided in this Act, be deducted from the total income derived by the taxpayer in the income year in which the expenditure or loss is incurred.

Unless there is express provision in the Act for deduction on any other basis expenditure or loss can be deducted from total income, in the year in which it is incurred. Generally, expenditure is deductible when it is incurred. There is an issue of time: when can an item of expenditure be said to be incurred by the taxpayer and how far forward can an expense be anticipated by the taxpayer and a deduction claimed.

The Ross Committee in the 1967 report *Taxation in New Zealand* recommended the amendment to the section as it was then (Section 111 of the **Land and Income Tax Act** 1954). The present section was drafted by the committee following the general lines of the Australian legislation which enabled the revenue to allow deductions for expenditure or loss which was not incurred in the year in which the income arose.

The words "for any income year" in Section 104, paragraphs (a) and (b) were added in 1968 to achieve the effect of allowing deductions for expenditure incurred in gaining or producing income in later years. Deductions are allowed for expenditure which is incurred in the production of income in future years.

The meaning of "incurred" has been judicially examined in *New Zealand Flax Investments v. Federal Commissioner of Taxation*.⁽²⁾ In speaking of the use of the word incurred in the Australian legislation upon which Section 104 was modelled Dixon J. said:

To come within that provision there must be a loss or outgoing actually incurred. "Incurred" does not mean only defrayed, discharged or borne, but rather it includes encountered, run into, or fallen upon.

It is unsafe to attempt exhaustive definitions of a conception intended to have various or multifarious application. But it does not include a loss or expenditure which is no more than impending, threatened or expected.

By the meaning propounded in the *New Zealand Flax* case, merely anticipated expenditure is not enough, there must be an element of certainty before expenditure or loss is incurred. The test of deductability was developed further in *Federal Commissioner of Taxation v. James Flood Property* ⁽³⁾ in respect of a claim that the taxpayer had incurred expenditure for taxation purposes rather than just making accounting provision for which calculating the amount for which the employer would be liable for annual leave. The amount could be computed in advance with approximate accuracy because annual leave depended on twelve months service. Even though no actual payments were

required the employee did become progressively entitled and the taxpayer progressively liable. The Full Court held that:

There was not an accrued obligation, whether absolute or defeasible. There was at best an inchoate liability in process of accrual, but subject to a variety of contingencies.

The failure to take account of other factors which could prevent an employee's right to annual leave such as death, dismissal, strikes or absenteeism, meant that the amount claimed as a deduction was not completely incurred and therefore was not deductible.

The word "incurred" in the *James Flood Property* case was interpreted to cover outgoings to which the taxpayer is definitely committed in the year of income even though there has been no actual disbursement.

The second is: Do the circumstances of the case, which include the techniques of *King v. Commissioner of Inland Revenue* (4) in the New Zealand Supreme Court. A contribution to pay to a reserve fund as required by statute was borrowed by the taxpayer and added to the amount of the loan secured by a mortgage. The objector James argued that the contribution was an expense incurred in the production of assessable income. On appeal from the Taxation Board of Review, Wild C.J. held that expenditure could not be construed so narrowly. The reasoning of *James Flood Property Ltd* was applied and Wild C.J. held that:

A deduction may be allowed under that section in respect of expenditure incurred although there has been no actual disbursement if, in the relevant income year the taxpayer is definitely committed to that expenditure. In this case the objectors were so committed.(5)

A legally enforceable liability can be incurred without knowing the precise amounts involved. It is enough that the obligation can be fairly quantified. In *Southern Railway of Peru Ltd v. Owen*(6) the House of Lords held that a deduction was possible for the retirement payments of employees. The company had to provide an accurate statement of the exact amounts that were involved. The House of Lords held:

Whatever the legal analysis, I think that for liabilities as for debts their proper treatment in the annual statements of profit depends not upon the legal form but upon the traders answer to two separate questions:

The first is: Have I adequately stated my profits for the year if I do not include some figure in respect of these obligations?

The second is: Do the circumstances of the case, which include the techniques of established accounting practice, make it possible to supply a figure reliable enough for the purpose.

The case failed on the facts as the company could not provide the accurate information required. The company had omitted to allow for discounting and provided each years increment at face value without provision for the likelihood that most staff would not leave or die.

The decision is difficult to reconcile with *James Flood Property Limited*. That case is authoritative on the meaning of incurred, that an actual disbursement is not required, but *Southern Railway of Peru*, lays down a stringent test on the degree of accuracy required in calculation before an expenditure can be deducted. It is likely that the *Southern*

Railway of Peru test would still be preferred in New Zealand. If an accurate estimation of the legal obligation incurred is not possible, the cases cited show that a deduction may be allowed only when the expenditure is actually made. The obligation cannot be incurred in the sense required by Section 104 until it has been estimated to a fair degree of precision. A liability which is merely anticipated will not be deductible.

This approach is in keeping with later decisions such as *RACV v. Insurance Property Limited* (7) where an insurance company could claim a deduction for estimated personal indemnity claims. The amounts claimed were estimated as being statistically necessary to cover claims arising out of events which had occurred during the income year but had not yet been the subject of an actual claim.

Any discussion of Section 104 of the Act would be incomplete without reference to Section 106 which is particularly relevant to the timing of deductions. Section 106(1)(a) allows no deduction when the following sums or matters are involved:

- (a) Investment, expenditure, loss or withdrawal of capital; money used or intended to be used as capital, money used in the improvement of premises occupied; interest which might have been made on any such capital or money if laid out at interest.

The section is important as it raises the question of the basis of tax law, whether an item is of a capital nature or an income nature; a question which is ultimately a question of law. Expenditure must be categorised as either capital expenditure which cannot be deducted or current expenditure which is able to be deducted. The court has formulated tests to meet the difficulties of determining the legal distinction between capital and current

expenditure. As Dixon J. expressed in *Hallstroms Proprietary Ltd v. Federal Commissioner of Taxation*.

The solution to the problem is not to be found by any rigid test or description. It has to be derived from many aspects of the whole set of circumstances some of which may point in one direction, some in the other. One consideration may point so clearly that it dominates other and vaguer indications in the contrary direction. It is a common sense appreciation of all of the guiding features which must provide the ultimate answer. Although the categories of capital and income expenditure are distinct and easily ascertainable in obvious cases that lie far from the boundary, the line of distinction is often hard to draw in borderline cases; and conflicting considerations may produce a situation where the answer turns on questions of emphasis and degree.(8)

Many tests have been applied to uncover the differences between capital expenditure and income expenditure. A consideration is that the recurrence of payments can be an indication whether they are of an income nature, or whether the payment was made "once or all".

Among the tests formulated are the enduring benefit test and the business entity factor. The enduring benefit test is the most favoured and demands closer attention. The test was formulated in the dictum of Viscount Cave L.C. in *British Insulated and Helsby Cables v. Atherton*.

when an expenditure is made, not only once and for all, but with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade, I think there is very good reason (in the absence of special circumstances leading to the

opposite conclusion) for treating such an expenditure as properly attributable not only to revenue but to capital.(9)

Put in these terms the test does seem to promote sound common sense but it is the application of the test to various fact situations which reveal the intricacies that can arise. No test is a matter of simple application.

For example in ***Kernball v. Commissioner of Taxes*** a claim for a deduction was made in respect of lump sum premium payments for the lease of two film projectors for a 10 year period by a cinema proprietor. The issue was whether the expenditure was made with a view to bringing into existence an asset which would be of enduring benefit for the business in question, and thus a capital expense. Myers C.J. saw that the appellant did have

... the right to retain and use the machines and equipment subject to the terms of the Agreements and to sell his business at an enhanced price because of his right to use the machine, and this is surely an asset. Then it is contended that the asset or advantage is not acquired for the enduring benefit of the appellant's trade or business, because his rights exist for only ten years. That seems to us to be immaterial. No plant, machinery or equipment acquired for the purpose of any trade or business can be expected to last forever. It has to be renewed at some period, which may be many or a comparatively few years, but none the less is acquired and intended for the enduring benefit of the trade or business.(10)

Illustrations of the principle in operation show how unclear its application is to any given situation. It is the borderline cases which cause the most difficulty. Lord Greene in ***IRC v.***

British Salmon Aero Engines Ltd agreed that in the hard cases. producing activity. The

it is almost true to say that the spin of a coin would decide the matter almost as satisfactorily as an attempt to find reasons.(11) In particular situations an asset which produces an enduring benefit will be income expenditure, in other situations capital.

The economic definition of capital expenditure does not have the same uncertainty. The economic definition is broader, and it is enough if expenditure will provide benefits to a business in any subsequent year is, in part, capital.

Certain categories of expenditure which are of a capital nature may be deductible in whole or in part in the year in which they are incurred under special provisions of the **Income Tax Act 1976**, as part of the government policy providing fiscal incentives and attracting investment to certain enterprises which are seen as important in the long-term economic development in New Zealand.(12) The effect of allowing deduction of capital expenditure items in the year in which the capital investment is made emphasises the lack of symmetry which arises between the timing of tax deductions and the recognition of income as the income benefits are spread over a number of future years.

Section 106(1)(h)(1) provides that interest payments cannot be deducted unless the Commissioner is satisfied that

it is payable on capital employed in the production of the assessable income.

The section makes interest deductible when it is payable in keeping with the provision in section 104 although the relationship between the two is not clear, that expenditure is deductible when it is incurred, as long as it is employed in income producing activity. The

provisions in Section 106(1)(h)(1) was anomalous with regard to certain financial arrangements which had no underlying capital such as a currency swap and could be subject to the new accrual. As indicated the relationship between Section 106(1)(h) and Section 104 is not always clear. Whether claims to deduct interest must satisfy both provisions or can rely on Section 106(1)(h) depends on whether there is sufficient connection between the expenditure of the interest and income earning activities.(13)

Postponement of Deductible Expenditure

Deductible expenditure may be postponed in some circumstances but not in others. Section 104 requires deductible expenditure to relate to the income of "any income year" in which it is incurred. If the taxpayer has gained an expense in the course of producing assessable income in an earlier year then in some situations, the taxpayer may deduct that expense.

In *Herald and Weekly Times Ltd v. Federal Commissioner of Taxation* (14) a newspaper company could deduct damages paid for a successful defamation case against the company when the tort occurred in an earlier income year. It can be expected that if the expense is incurred in an earlier income year, then it is possible to deduct that expense in a later income year if it was income produced in the course of the same business.

It is a general rule that the deduction can be only claimed if the business is continuing. If it has been disposed of or discontinued then no deduction is possible. It is in keeping with the provision of Section 104 and its reference to "any income year" that losses are deductible without regard to accounting periods.

Two lines of authority have been developed, in Australia based on the similarly worded section. **Amalgamated Zinc (de Bavay's) Ltd v. Federal Commissioner of Taxation** (15) a deduction was successfully challenged on the ground that the income from investments to which the annual payments to a workers' compensation fund was of a past year. The more correct view is that favoured by the majority of the Australian High Court who departed from **de Bavay's** case in **Australian Guarantee Corporation (Advances) Ltd v. Federal Commissioner of Taxation** (16). The taxpayer was a hire purchase financier which got into difficulties. Some years later, with another name, new shareholders and a new type of client, the taxpayer began another business of hire purchase finance. It wrote off some of the debts of the earlier business and claimed to deduct the resulting loss when calculating the income of its new business. Mason J. held that a loss was incurred when it had its origin which meant in this case during the carrying on of the earlier business. The authority of **de Bavay's** case must be doubted as a result of this decision. Banwick C.J. when discussing **de Bavay's** case said that the case

has nothing to say as to the deduction of losses. It is quite clear that the losses may not show up for years after money has been ventured on a business ... it seems to me not merely unjust but unacceptable to hold that it could not deduct that loss as a loss which it had incurred in the course of gaining accessible income(17)

Mason J. applied the test contained in the much earlier decision of **Ronpibon Tin NL and Onglicah Compound v. Federal Commissioner of Taxation** (18) which held that losses relating to the earning of income in previous years and not to the earning of income in the year in which the losses were incurred, does not mean that they cannot be deducted.

Mason J. concluded in **A.G.C. Advances Ltd**

that a loss having a business for profit should only be deductible whilst the business is still in operation, although the loss may not be ascertained until a later date, seems to me to be a strange result

(1953) 88 C.L.R. 492 @ 507

but the principle advocated by Mason J. has not been adopted consistently by the courts. Deductibility does not depend on accounting periods, but depends more on which the loss was incurred. In enacting accrual rules the legislature is recognising a mismatch of the timing rules, so that there is an ability to claim early deductions for interest expenditure and defer interest expenditure. The general test of deductibility is contained in Section 104 and Sections reinforcing the principles of that provision, all of which raise the issue of time, how far can an outgoing be estimated in the future and conversely, how far can the expense be removed in time from the income-producing activity by which it was incurred.

Consultative Document on Accrual Tax Treatment of Income and Expenditure

The ability to exploit the early availability of expenditure and the late recognition of income was made more significant by ingenious financial schemes, which made the statutory basis for the tests developed by the courts more outdated.

also currently deductible but these concessions are to be phased out commencing

the legislature was faced with something of a quandary, whether to aim at legislation which was a general and piecemeal thrust at inequities developed by reason of inappropriate timing provisions, or to be specific and detailed thereby providing a significant change. The latter course was deemed appropriate and the **Income Tax Amendment Act 1987** was enacted.

(1975) 132 CLR 175

ibid @ 187 - 188

(1949) 78 CLR 47

REFERENCES

- CHAPTER 4
- TAX AMENDMENT ACT - PART 1
- (1) Section 65 (2)(1)
 - (2) (1938) 61 C.L.R. 179 @ 207
 - (3) (1953) 88 C.L.R. 492 @ 507
 - (4) [1974] 2NZLR 190
 - (5) Ibid @ 195
 - (6) [1957] A.C. 334
 - (7) (1974) 4 ATR 610
 - (8) (1946) 72 CLR 634 @ 638
 - (9) [1926] AC 205 @ 213 (H.L.)
 - (10) [1932] NZLR 1305 (C.A.)
 - (11) [1938] 2 KB 482 @ 498
 - (12) **Consultative Document on Accrual Tax Treatment of Income and Expenditure**
October 1986. Page 10.
These categories include expenditure on scientific research. Agricultural, forestry and aquacultural development expenditure are other forestry capital expenditure also currently deductible but these concessions are to be phased out commencing in the 1988 income year.
 - (13) **Commissioner of Inland Revenue v. Banks** 3NZTC 61, 245 Richardson J @ 61, 246
 - (14) (1932) 48 CLR 113
 - (15) (1935) 54 CLR 295
 - (16) (1975) 132 CLR 175
 - (17) Ibid @ 187 - 188
 - (18) (1949) 78 CLR 47

CHAPTER 4

THE INCOME TAX AMENDMENT ACT - PART 1

The purpose of the **Income Tax Amendment Act** 1987 was to put in place accrual rules for the recognition of income and expenditure so that greater matching of the two was achieved. As we have seen in the previous chapters, timing is a crucial factor in correct income measurement. The nature of assessable income, the tests imposed by the courts when determining the recognition of income and the implementation of government policy, has meant that perfect matching can never be achieved.

Costs cannot readily be linked to any particular income, for example advertising costs or audit fees cannot be matched with the production of a certain income. The matching concept can also discriminate against businesses which have a long time between expenditure and results. The argument to counter what can be seen as major disadvantages of using a matching concept is that the legislation was not intended to match expenditure with income. That is an unrealistic objective. With a five year loan to plant a forest the interest is deductible over the five year term of the loan rather than when the forest is felled or sold and the revenue earned.

The provisions in the 1987 Amendment introduce new rules. Briefly these are first, the recognition of interest income and other returns on debt security, and secondly, the deductibility of certain categories of expenditure. Under the previous income tax

provisions, some returns on debt instruments which were equivalent to interest were usually exempt from taxation. Non-traders were not required to pay tax on gains for particular debt instruments, such as government stock, debentures and certain securities if the instruments were sold prior to redemption. The new rules make taxable all returns of interest on debt instruments, with some taxpayers being required to pay tax on this income as it accrues. Cash basis holders will be required to pay the interest income only when it is received. The requirement that a taxpayer be taxed on an accrual or a cash basis does not affect the total amount of the income that must be recognised.

The accrual rules have clarified situations which prior to their introduction were governed by the discretion and in-house practice of the Inland Revenue Department. There are now prescribed rules for the tax treatment of different taxpayers. We have seen that the position regarding liabilities in future years is complex. Section 104, in its literal sense could be said to authorise the deduction of a liability as soon as it is incurred. In a leasing agreement which requires the payment of rent in advance, the rental income and expense would be spread over the term of the lease for accounting purposes but the tenant would be entitled to deduct the income in full at the beginning of the period. The landlord would record the rental income as it accrued on a month by month basis. On the other hand, a legally enforceable leasing agreement does not entitle the tenant to deduct all the expenses for the rent in advance in reliance on the contract as having 'incurred' liability. The problems are not systematically addressed in reported judgments and so there are certain 'grey' areas in respect to timing where the department had a wide discretion.

determined pursuant to a determination (if any) made by the Commissioner under Section 64 E(1)(e) of this Act.

definition of financial arrangement is open-ended. It is essentially a debt or a debt instrument, a term used because it describes most of the arrangements involving the

Financial Arrangement

At the heart of the accrual rules is the definition of a financial arrangement. The accrual rules operate when there is income derived from or expenditure incurred pursuant to a financial arrangement.

The term financial arrangement is defined in Section 64 B(1):

"Financial arrangement" means -

- (a) Any debt or debt instrument; and
- (b) Any arrangement (whether or not such an arrangement includes an arrangement that is a debt or a debt instrument, or an excepted financial arrangement) whereby a person obtains money in consideration for a promise by any person to provide money to any person at some future time or times, or upon the occurrence or non-occurrence of some future event or events (including the giving of or failure to give notice); and
- (c) Any arrangement which is of a substantially similar nature (including, without restricting the generality of the foregoing provisions of this paragraph, sell back and buy back arrangements, debt deficiencies and assignments of income),

but shall not include any excepted financial arrangement that is not part of a financial arrangement that is attributable to an excepted financial arrangement, as determined pursuant to a determination (if any) made by the Commissioner under Section 64 E(1)(e) of this Act.

The definition of financial arrangement is open-ended. It is essentially a debt or a debt instrument, a term used because it describes most of the arrangements involving the

provision of credit. All conceivable types for the provision of credit are intended to be included, including government stock, treasury bills, kiwi bonds, commercial bills, a bank account, an overdraft, a mortgage, a loan, post-dated cheques, other bills of exchange, corporate bonds and debentures and so on.

The term debt instrument is not a simple one in the taxation context. The fundamental distinction is between an equity instrument which carries with it the elements of ownership and a debt instrument which constitutes evidence of a loan, advance or credit facility, or more broadly speaking the absence of ownership. In practice, however, the distinction between debt and equity instruments can be difficult to draw. Some debt instruments have the characteristics of equity and are treated for tax purposes as equity. By contrast, a number of equity instruments which have the characteristics of debt are treated for tax purposes as debt.

An example of the former category are debentures without a fixed interest rate which under Section 192 of the **Income Tax Act** 1976 companies can receive a deduction for interest paid on debentures if there is not a specific interest rate. In the category of equity instruments which are taxed as debt instruments are specified preference shares which are defined in Section 194 of the **Income Tax Act** 1976 as fully paid preference shares issued at par-value which are redeemable in cash at par-value or convertible into shares of any company no earlier than five years after allotment. These examples illustrate the extent of the reform to introduce a comprehensive accruals system.

Paragraph (b) of the definition of financial arrangement further defines any arrangement to include step transactions which are aimed at avoiding the accrual approach of the legislation. An excepted financial arrangement can be included if it is part of a wider arrangement.

The term 'arrangement' is further defined in the definition in section and Section 99, the anti avoidance provision, so that the two definitions are identical. The definition in Section 64 B(1) is:

Arrangement means any contract, agreement, plan or understanding (whether enforceable or unenforceable) including all steps and transactions by which it is carried into effect.

It was the intention of the **Consultative Committee** that the term 'arrangement' was used on its own so as to bring it within the definition of arrangement in this section. Paragraph (c) also was intended to eliminate potential avoidance. The language used in Section 106A(1)(c) defining non-recourse loans in the context of film financing which includes:

Any other arrangement, which, in the opinion of the Commissioner, is of a substantially similar nature.

Holder and Issuer

The parties to a financial arrangement are defined as the holder and the issuer.

The term holder is not restricted to the original holder but to any person who, if payments on the financial arrangement were due would have an unconditional legal right to the money.

The definition of holder is expressed in such a way that it would include any person who participated in a financial arrangement which entitled the receipt of payment.

Issuer is defined as a reflection of the term holder. An issuer is a person, who if payments on a financial arrangement were due would be liable to make payment.

The issuer is normally the borrower as that party will make the payments of interest. The definition does anticipate that there may be more than one issuer of a financial arrangement.

Variable Principal Debt Instrument and Fixed Principal Debt Instrument

There are two classes of "financial arrangement" also defined in the Act, a variable principal debt instrument and a fixed principal financial arrangement. If a fixed sum of money is lent they are fixed principal instruments. The main problem with a fixed principal instrument is when it is transferred. If the commercial bill, loan or mortgage as examples of fixed principal instruments were acquired by a person who was taxed on a cash basis in the year, all income from that instrument in each income year in which it is held is recognised on a cash basis. Likewise, if a fixed principal instrument is acquired by a person taxed on an accrual basis. Both rulings simplify the operation of the accrual rules, and ensure that no individual is double-taxed.

Variable principal instruments are those where records are not kept of the separate amounts of money borrowed or lent. Variable principal debt instrument presents particular problems when determining an implementation date and transfer of taxpayers from an accruals to a cash basis and vice versa. It is more straightforward to make an adjustment from an accruals basis or a cash basis as interest income will usually consist of periodic payments of interest.

Excepted Financial Arrangement

Excluded from the definition of financial arrangement is any excepted financial arrangement that is not part of a financial arrangement. An excepted financial arrangement standing on its own and without any circuitous route which disguises its real identity, is not subject to the accrual rules.

The exception to the definition of excepted financial arrangement which concluded the definition in the Bill so that it read "except where the arrangement is part of a financial arrangement" was deleted, as it led to confused circularity without any particular purpose as it was included in the definition of financial arrangement in any case.

The Commissioner can issue a determination if it is likely that an excepted financial arrangement could be included as a financial arrangement.

Annuities where the annuitant is a natural person, the proceeds from insurance policies and benefits provided from membership of superannuation schemes, debentures to which Section 192 or Section 195 of the Act applies, hire purchase agreements, short-term trade credits, specified preference shares to which Section 194 of the Act applies, shares in certain circumstances, a lease, and a bet in any game of chance or lottery, or prize competition are all exempt from the accrual rules.

A minor change to the bill as originally introduced was that the term "life insurance policy" was replaced by a contract of insurance and the term "superannuation scheme" was clarified to include membership of a superannuation scheme. All insurance contracts are outside the accrual rules. Superannuation schemes however are not, only membership of

a superannuation scheme.

(iii) Bloodstock

Some exemptions such as membership of a superannuation scheme and a contract of insurance were excluded because of an impending review by the government of taxation as it is relevant in these areas. Hire purchase agreements will be dealt with separately in a comprehensive review as a profit-emerging treatment would be more appropriate. Short-term trade credits are exempt for reasons of administrative convenience. Bets were not included by the committee as they depended purely on chance and were unlikely to involve the concept of time value of money.

Leases are removed from financial arrangements as it is included in the amended act in the unexpired expenditure provisions or in Section 222A and Section 222E of the Act. A definition of lease is included in the amended act so as to define what it is that does not come within a financial arrangement. The definition of lease as it was in the 1987 March amendment was again substantially amended, presumably because the previous definition which was significantly broader offered opportunities for avoiding the legislation. Both definitions are given in full here so that a comparison may be made. The first enacted definition read:

Lease means any agreement pursuant to which a lessor conveys to a lessee for a term property or the right to possession of property in consideration for any payment; and includes any contract of hire, bailment, licence, and any sublease.

The present definition reads:

Lease means -

- (a) A lease within the meaning of Section 222A(1) of this Act
- (b) An arrangement in relation to -
 - (i) Real property; or

(ii) Livestock; or

(iii) Bloodstock

that, if it were not in relation to property of that kind would be a lease within the meaning of paragraph (a) of this definition.

The relationship of the accrual provisions with the claimed transactions in Sections 222B and E remained uncertain under the old definition. The request that the provisions be clarified so that some indication was given as to how the specified lease would be treated came from comments on the **Income Tax Amendment Act 1987(1)**.

Money

Money has a wide definition, too wide in the view of some who see the approach as inappropriate.(2) It was the intention of the legislation to include all those things omitted from the definition of financial arrangement so that most commercial transactions involving future obligations are caught as a financial arrangement.

Acquisition Price

A series of rules are Section 64B for determining the acquisition price of a financial arrangement.

First, the definition refers to Section 64J which relates to non-market dispositions. If that section applies then the amount is determined pursuant to the market price. Secondly, if the financial arrangement is a trade credit which is defined in the Act to mean:

any debt for goods or services; but does not include a short-term trade credit then one of three methods can apply, the cash price method, the lowest price, or the discounted value of the amounts payable for the goods or services. Thirdly, if the previous two situations do not apply then the test is:

the value of all consideration provided by the holder in relation to the financial arrangement

The definition of acquisition prices was considerably expanded in relation to trade credits in the redrafted Bill which subsequently became law. Any advances by the holder are included in the acquisition price of a financial arrangement, which catches advances made subsequent to the initial acquisition.

Implementation Date

The Minister of Finance announced in the Budget statement of 31 July 1986 that the government was to introduce new income tax legislation which would achieve the greater matching of timing of deductions and the timing of income recognition by applying an accruals method to certain transactions.

The new rules governing the tax treatment of interest applied generally to debt instruments issued or acquired after 31 July 1986 unless they were acquired under a binding contract entered into prior to that time.

The general rule is that the implementation date is 8:30 p.m. New Zealand standard time on 31 July 1986 to coincide with the announcement in the 1986 Budget by the Minister of Finance. The accrual rules for deductibility of certain expenditure and for taxation of interest and other returns on debt instruments apply to all expenditure incurred and debt instruments issued after the implementation date except when a binding contract was entered into before the implementation date. If a binding contract was entered into prior to this date, so that the debt instrument was issued or acquired or expenditure incurred pursuant to a binding contract, then the accrual rules will not apply.

Certain classes of contract are subject to a different implementation time, which relates to the announcement by the Minister of Finance on 23 October 1986, of the new categories subject to accrual rules.

Forward or future contracts, including those for foreign exchange commodities, financial arrangements and excepted financial arrangements as well as futures contracts, trade credits, annuities and convertible notes have an implementation date of 8:30 p.m New Zealand standard time on 23 October 1986; instruments issued or acquired under binding contracts entered into on or before the announcement time will not be subject to the accrual rules. The application of the accrual rules to gains and losses on forward contracts or the purchase or sale of foreign exchange commodities and debt instruments is interesting and will be considered in more detail later. It is noteworthy that the definition of forward or future contracts but does not limit the definition to these.

Debt deficiencies and assignments of income have a later implementation date of 20 December 1986, which was a late addition and not included in the Bill as was originally introduced.

The reference to the New Zealand standard time is recognition by the legislature that some taxpayers could defeat the provisions by transacting arrangements in other time zones after the announcement. Variable principal debt instruments have an implementation date of 1 April 1987. The exception was put in the second draft of the **Income Tax Amendment Bill (NO. 2) 1** in recognition of the date signalled by the Consultative Document. Financial institutions were given more lead time and taxpayers would be required to calculate accrued interest from the commencement of the 1988 income year.

The change to an accrual method for variable principal instruments can have considerable impact on trading banks with overseas branches who have not been put on notice of the cut-off time so that the debt securities issued and acquired can be identified and posted.(3)

As we have discussed, a number of transitional adjustments were necessary to ensure that interest was not taxed and deducted twice or did not escape taxation completely. A longer warning time was also considered appropriate in the case of variable principal debt instruments because deferral opportunities were not as significant with these type of instruments.

Application - SECTION 64 M

The definition implementation dates is not autonomous but must be read in connection with the remainder of the provisions in the Act, in particular the application Section of 64

Section 64 M gives effect to the Budget announcement that changes to the treatment of financial instruments did not apply to instruments which were in existence prior to the announcement where the financial arrangement was issued or acquired by the person before the implementation date for the financial arrangement with a limited exception for future advances made under a financial arrangement in existence before the implementation date. After examining the evidence the Consultative Committee concluded that it would be inappropriate to exempt these sorts of contracts altogether as it would encourage the perpetuation of these financial arrangements for taxation advantages.

Any advance made after 1 April 1990 will be subject to the new accrual rules, giving holders and issuers the advantage of a generous lead in time.

Instruments in existence prior to the implementation date which were issued pursuant to a binding contract, will not be subjected to the accrual rules with the same exception for future advances as noted.

Matrimonial agreements are excepted which is consistent with the view taken in the **Income Tax Act 1976**, and in agreement with several submissions made to the Consultative Committee. The original Bill did not except matrimonial agreements.

CHAPTER 3

REFERENCES

- (1) **Submissions**, Fletcher Challenge Limited, 26 May 1987
- (2) **Submission**, D.L. Hinds Russell, McVeagh, McKenzie, Bartleet & Co
- (3) **Submission**, New Zealand Bankers Association, 1 October 1986

CHAPTER 5

ACCRUAL METHODS

The Consultative Committee agreed that a number of methods of accruing income and expenditure over the term of the debt instrument would be acceptable. The two that were preferred were the basic accrual approach and the market value approach. In the legislation the market value approach was accorded special treatment so the two concepts would not be confused. The market value approach could give a different result in some circumstances from the yield to maturity or accrual analysis. If the interest rate increased after the debt instrument was issued, the debt instrument would be discounted, so that the redemption price would be less than the issue or acquisition price to reflect the loss in comparative yield.

The calculations for income and expenditure respectively are contained in Section 64 C(2) which determines that the holder or issuer shall use the yield to maturity method.

If the yield to maturity methods cannot be applied by the terms of Section 64 C(3) taxpayers must follow a determination of the Commissioner that is applicable to that financial arrangement, the Commissioner having regard to the principles of accrual accounting. The alternative method must be in accordance with commercially acceptable practice, be consistently applied, and result in an allocation to each income year that is not significantly different from another method of calculation. Section 64 C(4) provides that the Commissioner may accept an alternative method for calculating income and expenditure if

the alternative method has regard to market valuation. The market valuation method accepted by the Commissioner must conform with commercially acceptable practice, be consistently applied in respect of all financial arrangements and the business of the person comprises dealing in financial arrangements or is a forward or future contract for foreign exchange. The method and the source of information used in the calculations must be approved by the Commissioner who has issued a determination and the holder and the issuer must not be associated persons.

Basis of Calculation

Section 64 C(1) establishes which payments to which accrual methods must be applied. Contingent and non-contingent payments of a certain amount must be included in the calculation of the yield on a financial arrangement. Contingent payments are paid as a result of the financial arrangement being issued or transferred. Non-contingent payments come within the definition if the total exceeds two percent of the acquisition price so as to prevent the return on a financial arrangement being concealed as a non-contingent payment.

Yield to Maturity Method

A yield to maturity of a debt instrument means the rate at which the yield on the debt instrument accrues over the term of the instrument. The yield is the same as the internal rate of return on the instrument with an apportionment of the interest returned on a daily basis.

The yield to maturity (YTM) method is the general principle prescribed in the 1986 Budget and the Consultative Document for the calculation of income and expenditure. No

definition is given of the yield to maturity method to be adopted. Confusing matters even more the Consultative Committee refers to both a basic accruals approach and an actuarial or yield to maturity basis as used in the United States.

The holder or issuer of a financial arrangement must use the yield to maturity method unless one of the alternatives apply. Section 64 C(2) reads:

... the amount that shall be deemed to be income or expenditure shall be an amount calculated using the yield to maturity method. (1)

Income is the amount calculated using the yield to maturity method. The definition of income is extended so as to include amounts which previously have been regarded as capital by reason of the blurred distinction between debt and equity.

The stated objective of Section 64 C(2) is to

to result in the allocation to each income year of an amount that is fair and reasonable.

The use of the yield to maturity accrual method means that to some extent the allocation of income or expenditure will be artificial in the sense that an amount will be calculated by the method and liability will arise accordingly. The legislature has anticipated the difficulties with a different approach to income incurred and expenditure derived and has enacted that

... such amount of income or expenditure so allocated to each income year shall be income deemed to be derived by or expenditure deemed to be incurred by the person in respect of the financial arrangement in the income year.

The information release from the Minister of Finance which accompanied the **Income Tax Amendment Bill (No 2)** 1986 noted these conceptual differences from the old tax regime and said:

The expressions "income derived" and "expenditure incurred" are given meanings ... that may differ from their currently accepted meanings in income tax law. The ordinary concepts regarding the nature of receipts and the time at which income is derived have no relevance in this new context.(1)

The yield to maturity recognises the economic theories involved when lending and borrowing money. The negative cash flow is the outlay of the money by the lender. The positive cash flow is the receipt of interest instalments. The discount rate by which the present value of the positive cash flow provided by a debt instrument will equal its price, is the yield to maturity method.

The correct present value is calculated by a financial calculator and microcomputer, so as to show the internal rate of return of the cash flow (including the purchase cost) of the debt instrument. However, it cannot be assumed that present values will be constant. This is uncertain. Interest rates in the future may rise or fall, which means that in principle, expected movements in interest rates should be taken into account when determining present values.

The simplest approach is the straight-line method which apportions interest income and expenditure on a pro rata basis. It can distort results as it overstates when income must be recognised and defers when expenditure may be deducted over a period of time.

The basic accrual approach for which the straight-line method is an accurate approximation of accruing income and expenditure, can be used for the following situations:

- (a) debt instrument which have a term to maturity which does not exceed twelve months; and
- (b) for all standard types of fixed, floating or reviewable interest rate instruments with terms which exceed twelve months but pay interest in the form of either:
 - (i) periodic interest paid at regular periods not exceeding six months and/or
 - (ii) a discount, premium or single deferred-interest payment.

The guidelines have been issued in the Consultative Document but of course, have no any legal effect. The difficulty using calculations involved in the yield to maturity method was anticipated by the legislation and accordingly in Section 64 E(1)(a) the Commissioner may determine how the yield to maturity can be applied to any financial arrangement for the purposes of Section 64 C(2). It is not surprising that Determination G3 issued by the Commissioner on 13 May 1987 addresses the application of the yield to maturity method. The determination states that:

There is no explicit formula for a yield to maturity in terms of the cashflows. The yield to maturity is defined as the discount rate at which the cashflows accumulate to zero.

Determination G1 on the same date concerns how daily income and expenditure may be apportioned on a straight-line basis. A choice may be made by the holder or issuer between a 365 day period which takes account of the actual number of days in the year or

a 360 day period which is a simplifying assumption that each year has 360 days (comprising twelve months with 30 days in each month).(2)

Market Value Accrual Option

The amount of income or expenditure calculated under the market value option may differ significantly from the amount calculated under the yield to maturity method. Dealers in financial arrangements are asked to apply the market value method. Non-dealers use the method when the financial arrangement is a forward or future contract for foreign exchange or a futures contract. No definition is given of the meaning of futures contracts but it can be understood to mean forward contracts traded on a futures exchange.

Any change in the market value of a debt instrument, plus any increase in the payments that the instrument produces, is income in the economic sense. The market value method allows a deduction for bad debts, which is the reason for restricting the method to certain classes of non-dealers and dealers in financial arrangements.

A bad debt means that the market value reduces. The income tax legislation allows only dealers in financial arrangements to claim a deduction for bad debts which are both income and capital. Non-dealers can claim a deduction for income bad debts only. The distinction is preserved in the market value accrual method.

Futures and forward contracts are included as they are perceived to have a low risk of bad debts and the market value method is more appropriate by reason of its simplicity.

The change in the market value of the expenditure or income of the financial arrangement in the year that it is issued or acquired minus the issue or cost price will be the market

value at the end of the year. For subsequent income years, the change in market value at the end of the preceding income year and the end of the income year in question will be measured by deducting the market value of the current income year from the earlier income year. If the financial arrangement is sold or redeemed there must be a final adjustment. To prevent taxpayers electing the market value method when it is more favourable the Act requires consistent application of the method for financial reporting purposes.

It is submitted that the bad debts provision implicit in the market value option serves to perpetuate and indeed, amplify already difficult provisions for the deduction of bad debts. The taxation treatment of bad debts is an appropriate subject for a general review.

REFERENCES

CHAPTER 5

- (1) Page 6
- (2) Submission from National Mutual on the Consultative Document dated 28 November 1986 suggested that the 360 day option be removed and that actual days be used saying ...

... incorporating the 360 day method makes things unnecessarily complicated for little perceived benefit.

Submission from Trustee Bank Holdings Limited dated 24 November 1986 made a similar recommendation

CHAPTER 6

EXEMPTION LEVELS

A variety of responses were received by the Consultative Committee concerning exemption levels and this is reflected in the **1986 Budget** and the **Income Tax Amendment Bills**. The threshold level adopted imposed the accrual rules on individual taxpayers if they earned or accrued income over the recommended amount. The majority of individual taxpayers would continue being taxed on a cash basis. The complexity of the accrual rules and the increase in compliance costs meant that individual taxpayers with small amounts of interest income are not required to recognise the income on an accrual basis.

Although the desire to avoid excessive compliance costs for individuals who receive smaller amounts of acquired income, is a reasonable aim, it is maintained that the exemption has no equitable basis between classes of taxpayers. The basis for imposing exemption is administrative convenience. The exemptions do introduce a complexity which unfairly burdens other taxpayers.(1)

There are two requirements which the individual, who must be natural person, has to fulfil to be classified as a cash basis holder and be exempted from the accrual rules. The first is in relation to income and investment levels, the second is based on the difference in calculations using accrual rules. The threshold levels for income in Section 64 D(1)(a) are:

- (1) the income derived during the income year from financial arrangements does not exceed \$50,000
- (2) the total value of financial arrangements held by an individual does not exceed \$400,000

Section 64 D(1)(b) provides that if the difference between the income calculated for financial arrangements held by the person under the accruals method and that income calculated as if the person were a cash basis holder does not exceed \$15,000 then cash basis holder status remains in place.

The Commissioner has a discretion in Subsection (2) of Section 64 D to except financial arrangements if a cash basis treatment results in a

... fair and reasonable allocation of income or expenditure among income years, for natural persons. The Commissioner is also able to exercise a discretion to impose accrual rules if a class of financial arrangements

has been structured and promoted with the objective of postponing any liability to income tax which would have arisen had these financial arrangements not been so structured.

Section 64 D(3) provides for taxpayers in transition from the cash basis to the accruals basis or vice versa. A cash basis holder must make an accrual basis adjustment in respect of every financial arrangement that has not been dealt with under Section 64 C or which the Commissioner has exercised a discretion granting status as a cash basis holder. If the person was not in the previous income year assessable on that basis, then a cash basis adjustment is required. A formula is provided in the Act to calculate the adjustment in each case.

In the initial Bill, the provision for a cash basis holder subsequently going onto an accruals basis was more simple. The holder of a fixed principal financial arrangement which was acquired in the year in which the person became a cash basis holder or assessed on an accruals basis, continued to be treated in the same way despite a change of status. The easier approach to the Bill was preferred by the Consultative Committee because of the lower compliance costs which would be associated with adjustment calculations. The method was abandoned as a result of oral submissions to the Committee which pointed out the requirement required a person to have two sets of financial arrangements, each having income calculated on a different basis. Consequently, any financial arrangements held by a taxpayer in a given year will be treated entirely on a cash basis or entirely on an accrual basis.

All interest income earned by companies and trusts must be recognised on an accrual basis. The alternative of allowing smaller companies and trusts to enjoy the exemption levels was considered by the Committee but rejected as leaving a loophole for significant tax avoidance or deferral. It could be argued that tax considerations, whether they be income splitting for tax purposes or an attempt to avoid the proposed accrual thresholds would not play a significant part in determining the form of the trusts. (2) Counter to this is the argument that if an exemption was granted for trusts, in view of the comprehensive nature of the reform, it would be likely that trusts would indeed become a mechanism for recognising interest income on a cash basis. On balance it is more appropriate to retain the exemption levels for natural persons only as it is more equitable.

Adjustment on Maturity or Transfer

Section 64 F is designed to bring financial arrangements which have been sold or redeemed into the accruals rules. The standard method of adjustment used is the base

price adjustment so that the taxpayer is required to pay tax on any gain that he or she has derived from the debt instrument which has not been taxed in prior income years. A deduction is allowed if the gain from the instrument is less than the amount of income which has been taxed in earlier income years. Therefore the base price adjustment ensures that the taxpayer is taxed on the total gain derived from financial arrangements minus its cost. The adjustment is equivalent to taxing the amount realised on sale plus any interest received or receivable in that year, with a deduction for the base price of the instrument.

The section has become the most controversial in the Act by reason of its impact on forgiveness of loans. Section 64 F(1)(c)(i) makes the forgiveness of a family loan subject to taxation pursuant to the provisions of Sections 64 F(2) or (3). These will be discussed in more detail later.

Section 64 F requires that an adjustment must be made in the income year in which a financial arrangement matures or is transferred. The definition of holder or issuer have been extended by this section so that a person who is no longer a holder or an issuer at the time the base price adjustment must be completed is included.

Section 64 F(1)(c)(i) is the section which has upset tax planning schemes which relied on a programme of gifting and forgiveness of debt. The inclusion of forgiveness of debt in the provisions has been described as a legislative oversight. The submissions to the Accruals Unit of the Inland Revenue which had invited comment on problems and issues arising from the 1987 amendment, expressed a lot of concern at the effect of this provision, seen by many as an unintentional result. Alarm was expressed at the need for redrafting of wills made which included the forgiveness of loans,(3) and that any estate planning involving family arrangements should become subject to the legislation was regrettable.(4)

The legislature has remained unmoved. Despite amendments to Section 64 F in the **Income Tax Amendment Act (No 2)** this provision remains unaltered, except to clarify dates. If a debt was forgiven in consideration of natural love and affection then the amount would be taken into account in the income year of the person, but it will not be included in determining that person's assessable income for the income year prior to the 1st October 1987.

Section 64 F(1)(c)(i) provides a definition of when financial arrangements have been remitted. This is when:

The issuer has been discharged from making all remaining payments under that financial arrangement without fully adequate consideration.

A financial arrangement is remitted when the issuer has been discharged or released from making all remaining payments. If a person ceases to be a New Zealand resident, the financial arrangement is transferred from that date for its market value. The taxpayer is required to be assessed on income from the financial arrangement prior to departure. The Committee expressed reservations about the exemption for non-residents but agreed that the position of non-residents was sensitive and not easily altered.

The term "maturity" in relation to a financial arrangement is defined to mean:

the date on which the last payment contingent upon the financial arrangement is made.

The amount of the base price adjustment if a financial arrangement matures or is remitted, sold or otherwise transferred, is calculated in accordance with a statutory formula which applies for a holder and an issuer.

Subsections (4) and (5) of Section 64 F provide that the amount of the base price adjustment whether a positive amount or a negative amount shall be deemed to be income derived by the taxpayer or an allowable deduction in calculating assessable income.

Subsection (6) directs that certain considerations for sale or transfer of a financial arrangement must not be taken into account when calculating the base price adjustment or cash base price adjustment. The calculations must be made on the basis of all amounts that would have been received by them regardless of any decline in the creditworthiness of the issuer, any increase in the possibility that the issuer might fail to meet obligations under the financial arrangement or as a result of the occurrence of any event reducing or cancelling the obligations of the issuer under the financial arrangement.

To summarize, if an arrangement is sold or transferred in response to any of the factors listed such as the default of the borrower, the general rule is that the base price adjustment cannot take account of the loss of the lender or make a deduction for a capital loss. The subsection does not apply if the business of the holder is dealing in financial arrangements.

Post-Facto Adjustment

Section 64 I provides for an adjustment when the terms of a financial arrangement are determined at the discretion of the parties. The adjustment is designed to prevent any attempts to defeat the accruals regime by associated persons who determine the financial arrangements on their discretion. The section applies if the change in the amounts payable under the financial arrangement do not reflect prevailing market conditions, the

making of such financial arrangements is not generally accepted commercial practice and the effect of the arrangement is to defeat the intent and application of the substantive provisions of the Act. The holder and issuer of the financial arrangement must calculate a post-facto adjustment for the income year in which the taxpayer ceases to be a holder or issuer. A calculation is also required in every fifth income year following the year of issue or acquisition by the taxpayer and every succeeding fifth income year.

Non-Market Dispositions

Section 64 J(1) is designed to catch financial arrangements which are not at arms length and is an anti-avoidance provision. The Commissioner must have regard to any connection between the parties when there is an issue or transfer of a financial arrangement and to any other relevant circumstances. It is submitted that the relationship between the parties must be established before any other relevant circumstances can apply. The words "any connection" are sufficiently wide enough to encompass most contingencies. The Commissioner must be satisfied that the parties were dealing with each other in relation to the issue or transfer of a financial arrangement in a manner that has the effect of defeating the intent, the intent and application of Sections 64 B to 64 M of this Act.

Accordingly the Commissioner may make the consideration equal to that which might reasonably be expected if the parties were dealing at an arms length with each other.

The provision was enacted in recognition of the ability of taxpayers, who may be associated persons, to act in concert to manipulate income tax liabilities by issuing or transferring financial arrangements at values other than the true market value. Section 64

J(2) deals with transfers between a non-residents fixed establishment in New Zealand and its other activities, whether overseas or in New Zealand. If the person becomes a New Zealand resident, the time at which that person receives that status is the time when the financial arrangement is acquired or issued. The person will have acquired the financial arrangement at the commencement of the period or alternatively disposed of the financial arrangement. In both situations it does not matter if the possession of the financial arrangement is temporary. The section requires that the transfer must be accounted for as if the acquisition or disposal had been made at arms length. Subsection 64 J(3) provides that in certain circumstances a financial arrangement may have been sold at the market price for a financial arrangement of that nature. If there is no market price it would have been sold and realised at the price determined by the Commissioner. The transfer must have acquired the financial arrangement for sale and disposal or the business of the transferor is comprised of dealing in such financial arrangement.

Bad Debts

Section 64 G contains provisions for deduction of bad debts which arise out of a financial arrangement. The section has independent application from Section 106(1)(b) of the Act. A deduction is permitted in any income year for bad debts which arise from any amount owing or to become owing in respect of a financial arrangement to which income is attributable to the amount for which the deduction is claimed and it is proved to the Commissioner's satisfaction that the amount was actually written off.

the business of the person comprises dealing in financial arrangements a deduction is permitted

... in respect of any amount owing in respect of the financial arrangement

REFERENCES

A dealer in financial arrangements is able to deduct capital which is outstanding and can be said to have gone bad by the criteria of the Act. The Commissioner must be satisfied that the amount has been actually written off and the issuer and the holder are not associated persons. Loans and advances secured by mortgages would not be dealing in financial arrangements. Bell Gully Buddle Weir dated 26th May 1987

(1) Submission from Peat Marwick dated 22nd May 1987

(2) Submissions from New Zealand Bankers Association dated 26th May 1987, D.F.C. New Zealand dated 25th May 1987

REFERENCES

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- (1) For example: Submission to Consultative Committee dated 28th November 1986 by Fletcher Challenge Limited, page 2.
- (2) Submission from the Public Trust Office dated 1st December 1986
- (3) Submission from Bell Gully Buddle Weir dated 26th May 1987
- (4) Submission from Peat Marwick dated 22nd May 1987
- (5) Submissions from New Zealand Bankers Association dated 26th May 1987, D.F.C. New Zealand dated 25th May 1987

CHAPTER 7

DETERMINATIONS

Section 64 E sets out the determinations procedure. The Commissioner's given the power to make certain determinations for the purposes of the accruals rules. The **Income Tax (Determination) Regulations 1987** lay down procedures. There is a procedure for objecting to determinations. The Commissioner is also able to vary, rescind, restrict, extend or replace any determination but without retrospective affect.

The ability of the Commissioner to make determination has been contentious with debate centred around the usurpal of the legislative role by the Commissioner whose function is to apply the law but not to state it. The Consultative Committee disputed the belief that the Commissioner had the ability to make law, rather he was a statutory functionary, under a legal duty to apply the tax law. In fact, the Committee replied, the ability of the Commissioner to issue determinations puts the Commissioner's role of statutory interpretation on public record. The taxpayer does have rights of objection which are explicitly provided by the section. In addition the taxpayer can make an objection later within the general framework of the Act, Sections 30, 31 and 32 of the **Income Tax Act 1976**.

The procedure to be followed in applying for, and the issuing of determinations is governed by the 1987 Regulations. The application must be made to the Commissioner and be comprised of the following matters:

- (1) payment of the fee
- (2) a draft of the determination sought as set out in the Regulations
- (3) the name and description of applicant
- (4) copies of all relevant document or extracts of such documents
- (5) the written submissions of the applicant
- (6) a draft of an anonymous version of the determination so that the name of the applicant and any particulars likely to identify the applicant are deleted

The Commissioner registers the application when he receives it and gives the applicant written notice of the date of registration. The Commissioner may request the applicant to produce more documentary material if it is required. Amendment of the application by the applicant is permitted as is withdrawal made by notice in writing.

The form of the determination is as laid down in the regulations, and can be summarised as explanation, reference, scope of determination, principle, interpretation, method and example.

A determination can be applied for showing how the yield to maturity method will be applied for any financial arrangement or how to calculate the accrual rates using the method prescribed by the Commissioner. The method used to determine market values, and the value of an excepted financial arrangement that is not part of a financial arrangement are included as subjects for determinations. Certain financial arrangements include elements which are attributable to excepted financial arrangements. For example options to buy shares are excepted financial arrangements when the shares or options were acquired before 8:00 p.m. New Zealand standard time on 18 June 1987. A convertible note may give the holder the option of redemption in shares or in cash. Section 4 E(1)(e) gives the Commissioner power to make a determination showing how the value

of an excepted financial arrangement which is part of a financial arrangement will be calculated. A determination by the Commissioner will detail the method for determining the discounted value of amounts payable for goods and services under trade credits. The amount of the trade credit is the difference between the cash price for the sale of goods or services and the credit price. The Commissioner has to determine a method of calculating the cash price of the goods where none exists. Accordingly the credit price of the goods or services must be discounted at an appropriate discount rate.

A determination is a formal application. The acceptance by the Commissioner of a method of accrual when an assessment is made does not constitute an assessment.

Determinations made by the Commissioner must be published in the Gazette within 30 days of making the determination.

The publication of determinations was introduced in reply to the number of submissions which saw publication as being essential so as to protect taxpayers from the dangers of the growth of a significant body of law of which there was no knowledge. Other taxpayers are able to determine their taxation liabilities if the determination is relevant.

The Commissioner is bound by the determination unless changes in the law make the determination obsolete or the determination was based on an application containing incorrect assumptions, whether intentional or not. Determinations made are binding on taxpayers.

The determination procedure increases certainty for taxpayers, although accrual rules are likely to continue to attract legislative attention and be amended with some frequency. The complexity of the accrual rules and the fertile imagination of those prepared to explore financial arrangement in a way which will bring them outside the provisions of the Act, almost certainly means that the legislation will need refining.

The Inland Revenue Department has had to make a commitment of resources to supply this service which imposes considerable demands on the accuracy and speed of the administration.

APPLICATION OF THE INCOME TAX AMENDMENT ACT

Determinations are valuable in terms of the benefits of certainty in commercial dealings, but are costly to produce. The application of a fee paying system, recognises that, although an individual taxpayer is providing information for the benefit of other taxpayers at no cost to those that may benefit from their initiative.

CHAPTER 8

APPLICATION OF THE INCOME TAX AMENDMENT ACT

1987 TO OTHER SECTIONS IN THE ACT

The timing of income recognition and deduction of expenditure is fundamental to the collection of revenue. The new accrual rules required changes of a substantive nature to provisions contained in the **Income Tax Act 1976**. The significance of the amendment can be appreciated more when assessing its impact on the standard taxing provisions in the legislation.

Section 65(2) relates to the term assessable items. The section provides that the assessable income of a person shall include certain categories of expenditure. Financial arrangements come within the scheme of the Act by extending assessable income to include income derived from financial arrangements.

Section 65(2) is amended by the addition of paragraph (ja) extending assessable income to include:

Income derived or deemed to be derived under Sections 64 B to 64 M of this Act.

Sections 64 B to 64 M contain the new accrual rules in the **Income Tax Amendment Act**

1987.

Section 104 is amended by the addition of Section 104A. The modification to Section 104 was essential in order to achieve matching of expenditure and income. Section 104A requires that there be matching up of any payment for goods and services in the income year to which each part of the expenditure relates. If expenditure is incurred for that income year then it is allowed, but any expenditure relating to future years is added back as assessable income. This expenditure is referred to as the unexpired portion of accrual income. These rules do not apply to trading stock, or in respect of financial arrangements, or a lease as defined in the No.2 Amendment and to a binding contract entered before 8:30 p.m. New Zealand standard time on 31 July 1986.

The test of deductibility is more restrictive than the former 'incurred' test. Taxpayers now must recognise as income amounts which they have incurred in a particular income year but which relate to a later period. This means that a deduction for all of the expenditure incurred in providing assessable income is allowed in the income year to which it relates, but that part of the expenditure relating to future years is added back into the taxpayers assessable income.

Section 104 is the major deduction section in the Act. The interpretation of the section has never been easy. Modification of the section could lead to considerable litigation to establish the application of the accrual rules. The determination procedures may assist in preventing some of the litigation for particular transactions, but the more significant and far-reaching application of the rules could depend on Section 104 as amended. The rules are complex and detailed and the potential for the rules not working in practice increases.(1)

Section 106 (1)(a) of the Act is amended by adding a proviso so that a deduction in respect of expenditure under the accrual rules is allowed. Certain deductions for types of capital expenditure, are prohibited and included in the list of prohibitions in the acquisition

price of any financial arrangement. The capital expenditure prohibition is lifted by allowing a deduction for expenditure under the accrual sections 64 B to 64 M. Similarly Section 106 (1)(h) is amended so that deductions of expenditure received for the purpose of the new accruals rules can be deducted as interest payable. If capital is employed in the production of assessable income and expenditure relates to this capital, any loss of interest may be deductible. The section was further amended in the 1986 No 2 amendment so that the meaning was clarified.

Section 192(1) of the Act is amended. The section deals with floating rate debentures. These are debentures which have a floating interest rate which is set in relation to a recognised market interest rate pursuant to a specified formula in the loan agreement.

Floating rate debentures are to be treated as equity when there is a direct relationship between the company's profits and the payment on the debentures.

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CONCLUSION

CONCLUSION

Business had exploited previous taxation timing rules by concentrating on gaps in the legislation in accounting for the borrowing and supplying of credit. All interest payments are now assessable and the definition of financial arrangement is sufficiently wide to bring into account a range of financial transactions.

The legislation has been criticised for being unnecessarily detailed and complex, making voluntary compliance more difficult to achieve. The legislators were faced with two potentially competing goals, to provide general accrual rules for the closer matching of interest income and expenditure which would defeat avoidance schemes as well as to provide precise guidelines for the application of the accrual rules. The detailed approach could not attract the approval of those who put the legislation into practice in the field but neither could a general broad-based approach assist, as it would be likely to fuel avoidance schemes once more.

An examination of the statutory framework shows how superimposing accrual rules on the legislation has indeed resulted in greater complexity. It also shows how timing issues are fundamental to income measurement.

Application of accounting principles can never truly measure income. There is a degree of arbitrariness in any measurement of income whether an accruals based method or not, as a time period is fixed from which an accurate assessment of assessable income must be reached. It assumes an equilibrium or steady state when none may exist.

It is for the law to determine what assessable income is for taxation purposes. This from the legal perspective, is a matter of elucidating the purpose and intention of the statute, narrowly in the case of taxing statutes, and applying the given facts to the law. Accounting principles may be taken into account in reaching a conclusion, but economic theories of income certainly not. The divergence of disciplines is of interest, and revealing when referring to the Consultative Document which brings economic principles of income to the law.

Legislation imposing a comprehensive approach to timing problems was overdue. The accruals method of accounting is a welcome addition to the legislation which underlines the need for constant vigilance in order to achieve an equitable taxation system.

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