COMPUTERS & LAW

NEWSLETTER FOR THE SOCIETIES FOR COMPUTERS AND THE LAW IN NEW SOUTH WALES, VICTORIA, SOUTH AUSTRALIA, WESTERN AUSTRALIA, QUEENSLAND, THE AUSTRALIAN CAPITAL TERRITORY AND NEW ZEALAND
Registered by Australia Post – Publication No NBG 8205

Editor: Elizabeth Broderick
February 1990 Number 12

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ISSN 08117225

COMPUTERS AND TAX IN NEW ZEALAND

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Contracts for the supply of hardware and software, maintenance and support and for computer developments often include a number of elements which do not fall neatly into the tax regime. This paper concentrates on the intricacies of the *Goods and Services Tax Act* 1985 (NZ) and the *Income Tax Act* 1976 (NZ) in relation to the computer industry in New Zealand.

Goods and Services Tax

Under the *Goods and Services Tax Act* 1985 (NZ), goods and services tax ("GST") is charged on the supply in New Zealand of goods and services by a registered person in the course or furtherance of a taxable activity carried out by that person. The tax is calculated by reference to the value of the supply. At present the rate is generally 12.5% but is 0% for certain transactions.

Broadly speaking, a taxable activity is likely to be any activity carried on continuously or regularly which involves the supply of goods and services to any other person for a consideration. This is wider than mere business activity and includes a wide range of trading activities. Certain activities are, however, specifically exempt from GST.

IN THIS ISSUE

The Purchaser's Perspective

If a purchaser receives goods and services from a registered person in New Zealand, then GST will be payable. The supplier will collect and pay over the GST to the Inland Revenue Department. The purchaser may however claim a refund of that GST (an input credit) if:

(a) he/she is a registered person; and

(b) the supply is one for use in a taxable activity.

Where a registered purchaser buys goods from an unregistered supplier, GST will not be payable. A registered purchaser is however entitled to claim one–ninth of the purchase price as an input credit.

If goods are exported by a registered supplier, the

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generated evidence update, trade marks and distribution contracts, computer piracy, and integrating technology systems.

We list details of several international conferences on page 28.

NEW ZEALAND SOCIETY

The Society would like to thank all speakers and members for their support during the past year and wish them a Happy New Year.

The Society held a successful seminar on Tax Issues in Computers in October. An extract of the seminar paper is included in this issue of the newsletter. A talk on CD-Rom Technology and its possibilities for the legal profession was held in December. A demonstration of CD-ROM/WORM equipment is planned for later this year.

The Copyright Law Reform Seminar planned for November last year was postponed till later this year.

On 28 March, the New Zealand Society will be holding an AGM at the Law Society Building, Level 3 at 1.00 pm. All members are welcome.

WESTERN AUSTRALIAN SOCIETY

The Western Australian Society for Computers and the Law Inc. has an exciting program planned for 1990. Their "Laptops for Lawyers" seminar was very well received (see page 24), and their forthcoming program is very comprehensive. Details are listed below.

APRIL – Litigation Support Seminar

A litigation support seminar directed at the legal profession in Perth is planned for early April 1990. A presenter will demonstrate various computer based tools to aid the litigation process. A judge, a barrister, and a solicitor will speak briefly about their experiences using litigation support packages.

Follow Up Workshop

A follow up workshop giving lawyers hands on experience with litigation support packages is planned for two or three weeks after the April seminar.

JUNE – JULY

A further series of seminars introducing lawyers to computers will be held in June or July.

SEPTEMBER – Seminar on New Intellectual Property Law

A seminar directed at the new Commonwealth intellectual property legislation is planned for some time in September.

LATE 1990 – Computer Exhibition

A computer exhibition may be held late in 1990 to show lawyers what legal software and hardware is currently available.

Details

Details of the above activities will be circulated, or contact the Secretary, Michael Paterson, GPO Box U1910 Perth WA 6001.

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non–resident purchaser should ensure that the supply is zero–rated (i.e. charged at 0%) rather than charged at the standard rate of GST (12 1/2%).

All goods imported into New Zealand are subject to GST at a rate of 12 1/2%. A registered purchaser will, however, claim a refund by way of an input credit. The value of goods for the calculation of GST on importation is the sum of the following:

(a) the value of the goods as determined by 9th Schedule of the Customs Act;

(b) the amount of any Customs duty levied; and

(c) the amount paid or payable to transport the goods to New Zealand and to insure the goods for such transport.

The Suppliers Perspective

If a supplier, resident in New Zealand, makes taxable supplies of more than $24,000 in any one year, then it must register for GST purposes and return GST to the Government on each transaction. It may register if it chooses (particularly if it wishes to collect input credits), if the level of taxable activity is lower than that figure.

Once registered, it must issued tax invoices on all supplies and return the GST to the Government.

If a New Zealand registered person makes supplies of goods and services to a non–resident then the supply will still be "taxable", but the rate of GST may be zero.

Zero rating is the best arrangement for suppliers, as tax credits can still be claimed for all GST paid on inputs, but there is no need to collect and return GST on the output.

If the supplier is overseas, there is generally no need to register for GST purposes. The supplier, though resident outside New Zealand, may, however, do sufficient business in New Zealand and incur costs in New Zealand to justify registration in order to claim input credits on those costs. Clearly, registration will be an administrative burden for many suppliers. The need for it can be avoided if the pricing and obligations between supplier and recipient are so arranged that the recipient meets all the New Zealand costs and claims the input credits.

Timing of Supply

The nature of computer contracts can give rise to problems in determining the time of supply (that is, the time at which the supplier becomes obliged to return GST to the Inland Revenue Department and the recipient becomes entitled to claim an input tax credit).

In general, for the supply of goods or services, the time of supply will be the earlier of the date of issue of an invoice or the date of payment for the goods or services.

However, where goods or services are supplied progressively or periodically pursuant to an agreement which provides for periodic payments or payment by instalments, then each of the successive supplies shall be deemed to take place when a payment becomes due or is received or where an invoice relating to that payment is issued.

Thus for a 12–month maintenance agreement or a purchase agreement extending over a long period of time, the contract should be structured so that GST is payable over the period rather than at the start of the project. Where an invoice is issued for the whole consideration at the time the contract is entered into, the supplier will be obliged to pay the full amount of GST to the IRD (irrespective of whether the supplier has received it from the purchaser or not). In such circumstances, the contract should make specific provision for periodic payments over the term of the contract, so GST will arise at the time of each payment.

"Payment" includes all or any part of the purchase price. Thus, putting down a deposit on a supply of goods amounts to 'payment' and a supplier will be liable to pay the GST on the full value of the goods to the IRD at that time. Care should, therefore, be taken where agreements are structured so that a relatively low deposit is paid on high value goods.

Exempt Services

The main exception to the definition of 'taxable activity' is any activity to the extent that it involves the making of "exempt supplies". The main one of those is the supply of financial services, but there are other exceptions relating to some of the activities of non–profit bodies and to rental accommodation.

GST is not charged on the supply of exempt services but input credits cannot be claimed on the cost of goods and services incurred in respect of the supply of those exempt services. Thus, a person engaged both in taxable activities and in the supply of exempt services will need to apportion inputs between the two activities. The only exception is where the exempt services represent only a small part of the person's activities (the lesser of $48,000 per annum or 5% of the total supplies by that person).

Following the case of *The Commissioner of Inland Revenue v Databank Systems Limited* (New Zealand Court of Appeal, April 1989, CA204.87), the GST Act is to be amended to make it clear that the provision of computer services is a taxable supply, even if the services are used for financial services. Thus Databank, or a bureau, must collect GST from its users and will be able to claim input credits. However, the internal costs of computers used in a financial institution (on which the institution pays GST to the supplier) do not give rise to an input credit, except to the extent that the institution makes taxable supplies in addition to its exempt supplies.

Withholding Tax on Payments to Non-Resident Contractors

The *Income Tax (Withholding Payments) Regulations* 1979 (NZ) (the "Regulations") impose a withholding tax on credit specifically defined "withholding payments". Essentially, the tax is imposed as an "at source" deduction to ensure that a specified level of taxation is received with respect to certain classes of persons.

The withholding tax is imposed at the rate of 15% on payments made to non–resident contractors (i.e., companies, firms and individuals) in respect of specified contract activities or services performed in New Zealand. These activities or services include the installation and maintenance of computers and computer equipment. Certain payments are, however, specifically excluded from the withholding tax; these include:

(a) payments which are in the nature of salary or wages;

(b) royalties, as defined in the *Income Tax Act*; and

(c) cost reimbursing payments.

The responsibility is placed on the employer of the non–resident contractor to deduct the 15% withholding tax and pay the amount withheld to the Inland Revenue Department. The tax is calculated on the gross payment made to the contractor.

Exemptions

Non–resident contractors, who receive payments to which the withholding tax applies, have the right to apply to the Commissioner for an exemption certificate.

The circumstances in which exemption certificates may be obtained are:

(a) the Commissioner is satisfied that any income derived by the non–resident contractor is not subject to New Zealand income tax by reason of a double taxation or for any other reason;

(b) the non–resident contractor gives the Commissioner a bond or other form of security satisfactory to the

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1990 MEMBERSHIP

New South Wales Society for Computers and the Law

The Society brings together, for informal and formal discussions, lawyers and others actively working in the information technology field in private practice, corporations and in Government. Join now for 1990. Membership entitles you to our Newsletters, a copy of the Proceedings, plus attendance at our monthly meetings.

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Commissioner securing the payment in terms acceptable to the Commissioner of any New Zealand income tax payable;

(c) the Commissioner is satisfied that the non–resident contractor has met its New Zealand income tax obligations during the preceding two year period and will continue to do so in the future.

The *Double Taxation Relief (Australia) Order* 1972 (the "DTA") provides relief from taxation in both countries in certain instances. Similar arrangements are in effect between New Zealand and many other countries.

Article 5 of the DTA provides that industrial or commercial profits are subject to tax outside the country of residence of the recipient of the payment only if the recipient has a "permanent establishment" in the other country.

Assuming that the contractor is not deemed to have a permanent establishment in New Zealand, tax will not be assessed on the payments in New Zealand if they are payments coming within the definition of "industrial or commercial profits". "Industrial or commercial profits" are profits derived from the conduct of a trade or business. That definition would appear to include most payments but no remuneration for personal (including professional) services.

There is provision for a non–resident contractor to apply to the Revenue Authorities for a "reduced rate certificate" which allows tax to be withheld on the anticipated net tax liability payable. It is relevant to note that the 15% rate was apparently struck on the assumption that most contracts will run at a 30% profit margin and that the imposition of the non–resident corporate tax rate of 50% would result in a net liability of 15%. In the present environment many contractors budget for a profit margin and substantially less than 30% and the present non-resident tax rate is 38%. In these circumstances, non-resident contractors should consider applying for a "reduced rate certificate".

Non–Resident Withholding Tax

Essentially non–resident withholding tax ("NRWT") is a tax payable on interest, dividends and royalties paid by a New Zealand resident to a non–resident. Those persons making the payments are required to deduct and pay to the Inland Revenue Department a percentage of the gross amount payable to the non–resident.

In relation to the computer industry the most relevant form of non–resident withholding income is that of "Royalties".

What are Royalties?

Section 2 of the Income Tax Act defines the term "royalty"; included in that definition are the following:

Any payment as consideration for:

- The use of, or the right to use, any copyright, patent, trademark, design or model, plan, secret formula or process, or other like property or right;

- The supply of scientific, technical, industrial, or commercial knowledge or information; and

- the supply of any assistance which is furnished as a means of enabling the application or enjoyment of anything referred to in the above paragraph.

The IRD, in their Public Information Bulletin 168 published in January 1988, outlined their interpretation of what, in the computer industry, constitutes a royalty, as:

(a) all licence fees payable for the acquisition or use of software; and

(b) all payments for services performed in New Zealand or

overseas in connection with the application or enjoyment of the software.

We believe that the IRD's view is far too wide and that many payments under licensing agreements are not royalties.

In terms of the definition in section 2 of the Act, we believe the following would be regarded as a "royalty";

- A licence which provided for the "use of a copyright" (as opposed to the item under the copyright) where that copyright related to a source code and, in some circumstances, (such as in *IBM v Computer Imports Limited and Ellis Bros*, March 1989) the object code;

- A licence which gave the licensee the right to use a "source code". In these circumstances, it would be regarded as a right to use a "secret process";

- A licence, in terms of which the licensee was supplied with the source code. In these circumstances, it would be regarded as a supply of technical information; and

- Any assistance furnished by the licensor in respect of the above supplies.

The supply of an object code under a licence will not, in our opinion, generally be regarded as a royalty. It should be noted, however, that the IRD would, in all likelihood, dispute our interpretation of the definition of royalty. We understand that they regard all licence fees paid on all forms of software as royalties, so if you were to treat them differently you can expect some argument with the Revenue Authorities.

Cost of Non-Resident Withholding Tax

The rate of non-resident withholding tax on royalties is generally 15%, but that is subject to modification under a number of double taxation agreements.

Most double taxation agreements provide that no tax may be levied on royalties if the payee has a permanent establishment in New Zealand.

While most software agreements have some form of tax indemnity in them, the particular wording of the agreement should, however, enable the purchaser to deduct the payment of NRWT from the amount otherwise due to the supplier. The tax is clearly imposed as a tax on *income* by s311 of the Act.

In almost every case, the recipient of the payments would obtain a credit in his country of residence for the withholding tax already paid to the New Zealand IRD. In most cases therefore the recipient will effectively recover the tax, although there will certainly be a timing cost.

If the Commissioner disagrees with the amount of NRWT deducted and paid, he can issue an assessment in respect of the shortfall. The normal assessment and objection procedures (ss23, 26, 27, 28 and 29) will then apply.

There are penalties for failure to deduct and account for NRWT.

- *This paper is an edited version of the detailed papers given at the seminar on "Computers and Tax" held by the New Zealand Society for Computers and the Law in October 1989.*