

INCOME TAX AMENDMENT BILL (NO. 2)

EXPLANATORY NOTE

THIS Bill amends the Income Tax Act 1976 in respect of the accrual rules for the recognition of income and expenditure.

Clause 1 relates to the Short Title and application date.

Clause 2 (1) inserts new *sections 64B to 64J* in the principal Act.

Section 64B is the general interpretation provision. It contains a definition of the term “financial arrangement”, being broadly defined so as to include any arrangement or series of arrangements whereby a person obtains money or money’s worth for a period, and any substantially similar transaction. Each arrangement in the series may or may not itself be a financial arrangement. There are a number of exceptions for financial arrangements consisting solely of certain specified types of instruments. The section also defines the term of “implementation date” for various financial arrangements. Arrangements issued or acquired after the implementation date are subject to the new accrual rules.

Subsection (2) provides that, for the purposes of *sections 64B to 64J*, all references to an income year shall be deemed to be a reference to the taxpayer’s accounting year.

Section 64C: Subsection (1) provides that income and expenditure in relation to financial arrangements shall be calculated using the yield to maturity method, where that may be applied to the arrangement, so as to result in the allocation to each income year of an amount that is fair and reasonable.

The proviso gives the Commissioner discretion to accept alternative methods, which have regard to accruals or market valuation, are commercially acceptable, conform with the taxpayer’s reporting methods, and do not give a materially different result from the yield to maturity method.

Subsection (2) provides for arrangements to which yield to maturity methods cannot be applied. Taxpayers that have issued or acquired such arrangements must follow any determination of the Commissioner that is applicable to the arrangement. In the absence of a determination relating to a particular arrangement, the taxpayer is required to use a method which has regard to accruals or market valuation, is commercially acceptable, conforms with the taxpayer’s financial reporting methods, and results in the allocation to each year of a fair and reasonable amount, reflecting the taxpayer’s income or expenditure

in relation to the arrangement. That amount is then deemed to be income or expenditure as the case may require.

The proviso to this subsection allows an alternative method to be adopted where the Commissioner has made a determination. The alternative must have regard to accrual or market valuation, conform with commercially acceptable practice, be adopted by the taxpayer for financial reporting purposes, and result in the allocation among income years of amounts not materially different from those which would result from the application of the Commissioner's determination.

Subsection (3) provides for exceptions from the yield to maturity requirement where—

- (a) The cash basis exception applies; or
- (b) The financial arrangement was issued pursuant to a binding contract in existence before the implementation date; or
- (c) The financial arrangement is made under a roll-over or extension provided for before the implementation date in a binding contract in existence before the implementation date; or
- (d) The financial arrangement is used by a non-resident for the purposes of a business carried on outside New Zealand; or
- (e) A non-resident is subject to non-resident withholding tax on income from the financial arrangement.

Subsection (4) provides that existing provisions which specify how income or expenditure from financial arrangements shall be calculated shall be read subject to *sections 64B to 64J*. This does not apply to section 99 of the principal Act.

Section 64D provides for an exemption from the rules in relation to income derived by natural persons who either—

- (a) Earn less than \$50,000 income per annum from financial arrangements; or
- (b) Have less than \$400,000 invested in financial arrangements. Exempted persons will continue to account for interest income under existing rules, except for an adjustment on disposition of financial arrangements. Interest expense will have to be accounted for under the accrual rules.

Subsections (2) and (3) provide that income on fixed principal financial arrangements acquired by a taxpayer when on one basis shall continue to be calculated by that taxpayer on that basis in succeeding years, regardless of changes in the taxpayer's status.

Subsection (4) provides that all income and expenditure from financial arrangements held in trust shall be calculated on an accruals basis, and shall not be taken into account in determining individual exemption levels.

Subsection (5) applies the usual income tax treatment of partnership income. The income and assets are regarded as being derived or held by the individual partners directly, according to the terms of the partnership.

Section 64E empowers the Commissioner to make determinations to ensure compliance with *section 64C*. The Commissioner may issue determinations as to how the yield to maturity method applies to any financial arrangement or class of financial arrangements. He may determine what other methods may be used in respect of arrangements under *subsection (2) of section 64C*. He may also approve methods for use under the provisos to *subsections (1) and (2)* of that section.

Subsections (2) and (3) provide that determinations may be objected to in accordance with the provisions of Part III of the Act.

Subsection (4) provides that determinations may be revoked by the Commissioner, but without any retrospective effect.

Section 64F provides for the base price adjustment, which ensures that a taxpayer's total income or expenditure over the life of an arrangement is taken into account for tax purposes.

Subsections (3) and (4) provide that the base price adjustment, whether a profit or a loss figure, shall be taken into account in calculating a taxpayer's assessable income.

Subsection (5) prevents the base price adjustment being used to allow a deduction for bad debts. The amount of any deduction allowed cannot exceed the amount of income assessed.

Section 64G provides that any amount returned as accrued income but not received because of the borrower's default is to constitute a bad debt for the purposes of section 106 (1) (b) of the principal Act.

Section 64H provides for the disclosure of information in respect of arrangements which form part of a financial arrangement, whether or not those constituent arrangements are themselves financial arrangements.

Section 64I provides for an adjustment where, for the purposes of applying the yield to maturity method, an estimate of future cash flows has been made. Once each cash flow becomes known, an adjustment is made in that income year to the taxpayer's assessable income, if required.

Section 64J provides that where a financial arrangement is issued or transferred other than at arm's length, the consideration shall be deemed to be the consideration that might have been expected if the parties had been at arm's length.

Subsection (2) enables *subsection (1)* to be applied to determine a transfer price in relation to transactions between New Zealand residents and non-residents, such as New Zealand and off-shore branches of a non-resident company.

Clause 2 (2) amends the definition of the term "paid" in section 2 of the principal Act to include a reference to "financial arrangement".

Clause 2 (3) includes a new paragraph (jb) in section 65 (2) of the principal Act to include income from financial arrangements in assessable income.

Hon. R. O. Douglas

INCOME TAX AMENDMENT (NO. 2)

Title	ANALYSIS
1. Short Title and application	64F. Income and expenditure where financial arrangement redeemed or disposed of
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<i>Accrual Treatment of Income and Expenditure</i>	64H. Inter-related arrangements
64B. Interpretation	64I. Adjustments to estimated accruals of income and expenditure in respect of financial arrangements
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A BILL INTITULED

An Act to amend the Income Tax Act 1976

1 1. **Short Title and application**—(1) This Act may be cited as the Income Tax Amendment Act (No. 2) 1986, and shall be read together with and deemed part of the Income Tax Act 1976* (hereinafter referred to as the principal Act).

(2) This Act shall apply with respect to the tax on income derived in the income year that commenced on the 1st day of April 1985 and in every subsequent year.

10 2. **New sections inserted relating to accruals**—(1) The principal Act is hereby amended by inserting, after section 64A (as inserted by section 11 of the Income Tax Amendment Act (No. 2) 1985), the following subheading and sections:

“Accrual Treatment of Income and Expenditure

15 “64B. **Interpretation**—(1) For the purposes of this section and sections 64C to 64J of this Act—

*R.S. Vol. 12, p.1

Amendments: 1983, No. 4; 1983, No. 10; 1983, No. 139; 1984, No. 10; 1985, No. 1; 1985, No. 59; 1985, No. 146; 1986, No. 3; 1986, No. 7; 1986, No. 41

- “ ‘Acquisition price’, in relation to a financial arrangement, means—
- “(a) Where the parties to the financial arrangement are dealing with each other at arm’s length, the value of all consideration paid or given in relation to the acquisition of the financial arrangement: 5
- “(b) In any other case, the amount determined pursuant to **section 64J** of this Act:
- “ ‘Arrangement’ means any contract, agreement, plan, or understanding (whether enforceable or not), 10 including all steps and transactions by which it is carried into effect:
- “ ‘Cash basis holder’ means a holder to whom **section 64b (1)** of this Act applies:
- “ ‘Excepted financial arrangement’ means any of the 15 following arrangements:
- “(a) An annuity where the annuitant is a natural person:
- “(b) A life insurance policy or superannuation scheme: 20
- “(c) A debenture to which section 192 or section 195 applies:
- “(d) A hire purchase agreement (as defined in section 2 of the Hire Purchase Act 1971) or an assignment of such an agreement: 25
- “(e) A short term trade credit:
- “(f) A specified preference share to which section 194 of this Act applies:
- “(g) A redeemable preference share,— 30 except where the arrangement is part of a financial arrangement:
- “ ‘Financial arrangement’ means—
- “(a) Any debt instrument; and
- “(b) Any arrangement (whether or not such arrangement includes an arrangement that is a debt 35 instrument, or an excepted financial arrangement) whereby a person obtains, or persons obtain, money, the right to money (including the deferral of any obligation to pay money) or the right to a debt instrument or an excepted financial arrangement in 40 consideration for a payment or promise to pay money at some future time or times, or upon the happening of some future event or events (including the giving of notice); and

5 “(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),— but shall not include any excepted financial arrangement:

“ ‘Fixed principal financial arrangement’ means any financial arrangement other than a variable principal debt instrument:

10 “ ‘Holder’, in relation to a financial arrangement at a particular time, means the person who, if the amount or amounts payable under the financial arrangement were due and payable at that time, would be entitled to receive payment of the amount or amounts so payable:

15 “ ‘Implementation date’ means—

“ (a) In the case of—

“ (i) Forward or future contracts including, but not limited to, contracts for—

20 “ (A) Foreign exchange:

“ (B) Commodities:

“ (C) Financial arrangements:

“ (D) Excepted financial arrangements; and

25 “ (ii) Futures contracts; and

“ (iii) Trade credits; and

“ (iv) Annuities; and

“ (v) Convertible notes to which **section 196** of this Act applies,—

30 8.00 p.m. New Zealand Standard Time on the 23rd day of October 1986; and

“ (b) In every other case, 8.30 p.m. New Zealand Standard Time on the 31st day of July 1986:

35 “ ‘Issue’, in relation to a financial arrangement, means the act of creating the financial arrangement, and ‘issued’ has a corresponding meaning:

40 “ ‘Issuer’, in relation to a financial arrangement at a particular time, means the person who, if the amount or amounts payable under the financial arrangement were due and payable at that time, would be liable to pay the amount or amounts so payable:

“ ‘Maturity’, in relation to a financial arrangement, means the date on which the last payment under the financial arrangement is due and payable:

45 “ ‘Money’ includes money’s worth:

“ ‘Short term trade credit’ means any debt for payment of goods or services where payment may be required by the vendor within 61 days after the supply of the goods or services:

“ ‘Superannuation scheme’ means any superannuation fund and any superannuation category 3 scheme: 5

“ ‘Trade credit’ means any debt for payment of goods or services where the payment may be required by the vendor after a stipulated period after the supply of the goods or services, but does not include a short term trade credit: 10

“ ‘Variable principal debt instrument’ means a bank deposit account or other instrument where it is contemplated that the holder may—

“(a) Advance further sums to the issuer; or 15

“(b) Require the return of sums advanced to the issuer,—

in either case upon demand or call, and where all such sums form part of that bank deposit account or other instrument. 20

“(2) Every reference in **subsection (1)** of this section and **sections 64c to 64J** of this Act to an income year shall, where a taxpayer furnishes a return of income under section 15 of this Act for an accounting year ending with an annual balance date other than the 31st day of March, be deemed to be a reference to the accounting year corresponding with that income year, and, in every such case, those provisions shall, with any necessary modifications, apply accordingly. 25

“**64c. Accruals in relation to income and expenditure in respect of financial arrangements**—(1) Subject to this section,— 30

“(a) In respect of any financial arrangement, acquired by any person on or after the implementation date for the financial arrangement, the amount of income derived by the holder shall be an amount calculated by the holder using the yield to maturity method so as to result in the allocation to each income year of an amount of income that is fair and reasonable, and such amounts of income so allocated to any income year shall be deemed to be income derived by the holder in that income year: 35 40

“(b) In respect of any financial arrangement, issued by any person on or after the implementation date for the financial arrangement, the amount of expenditure

incurred by the issuer in respect of that financial arrangement shall be an amount calculated by the issuer using the yield to maturity method so as to result in the allocation to each income year of an amount of expenditure that is fair and reasonable, and such amounts of expenditure so allocated to any income year shall be deemed to be expenditure incurred by the issuer in that income year:

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“Provided that the Commissioner may accept an alternative method to the yield to maturity method, that has regard to accrual or market valuation, where it—

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“(c) Conforms with commercially acceptable practice; and

“(d) Is adopted by the taxpayer and is or is intended to be consistently applied for financial reporting purposes; and

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“(e) Results in the allocation to each income year of amounts that are not materially different from amounts that would be calculated but for this proviso.

“(2) Where it is not possible to calculate an amount of income or expenditure in respect of a financial arrangement to which **sections 64B to 64J** of this Act apply using the yield to maturity method as provided for in **subsection (1)** of this section, an amount of income or expenditure for each income year shall be calculated by the taxpayer for any such financial arrangement,—

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“(a) Using the method, if any, prescribed by the Commissioner for the financial arrangement in a determination made under **section 64E (1) (b)** of this Act:

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“(b) In the absence of any such determination, by applying a method that satisfies **paragraphs (c) to (e)** of the proviso hereto and that results in the allocation to each income year of an amount that, having regard to the tenor of **section 64c (1)** of this Act, is fair and reasonable and reflects the taxpayer’s income or expenditure in relation to the financial arrangement,—

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and the amount of income or expenditure so calculated shall be deemed to be income derived or, as the case may be, expenditure incurred by the taxpayer in the income year:

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“Provided that the Commissioner may accept an alternative method for calculating income and expenditure to the method prescribed in any determination made under **section 64E (1) (b)** of this Act if the alternative method—

- “(c) Has regard to accrual or market valuation; and
“(d) Conforms with commercially acceptable practice; and
“(e) Is adopted by the taxpayer and is or is intended to be consistently applied for financial reporting purposes; and 5
“(f) Results in the allocation among income years of amounts that are not materially different from the amounts that would be calculated, but for this proviso, using the method prescribed in the applicable determination made by the Commissioner under 10 **section 64E (1) (b)** of this Act.
- “(3) **Subsections (1) and (2)** of this section shall not apply—
“(a) Where **subsection (1) or subsection (2) of section 64D** of this Act applies:
“(b) Where the issue or acquisition of the financial 15 arrangement is pursuant to a binding contract in existence before the implementation date in relation to that financial arrangement; or
“(c) Where the issue or acquisition of the financial arrangement is pursuant to and in terms of a roll- 20 over or extension provided for before the implementation date in relation to the financial arrangement; or
“(d) To the determination of—
“(i) Income of or expenditure incurred by a 25 person not resident in New Zealand in relation to a financial arrangement where and to the extent that the financial arrangement does not relate to a business carried on by that person through a fixed establishment in New Zealand; or 30
“(ii) Non-resident withholding income.
- “(4) To the extent that any provision of this Act, other than section 99, conflicts with **sections 64B to 64J** of this Act that provision shall apply subject to the treatment of income and expenditure in relation to financial arrangements prescribed 35 by the said **sections 64B to 64J**.
- “**64D. Cash basis holder**—(1) Subject to this section, a natural person shall be exempt from the provisions of **section 64C** of this Act, in relation to all financial arrangements acquired on or after the implementation date, and held by the 40 person in any income year, where—
“(a) The income derived by that person in that income year from those financial arrangements, calculated in accordance with **section 64C** of this Act, does not

exceed \$50,000 (or such greater amount as the Governor-General may from time to time, by Order in Council, declare); or

5 “(b) The total value of financial arrangements held by the person in the income year does not exceed at any time in the income year \$400,000 (or such greater amount as the Governor-General may, from time to time, by Order in Council declare), the value in respect of each financial arrangement being—

10 “(i) In the case of fixed principal financial arrangements, the greater of—

“(A) The acquisition price of the arrangement; or

“(B) The nominal or face value of the arrangement:

15 “(ii) In the case of variable principal debt instruments, the amount of money owing to the person pursuant to the arrangement.

“(2) Where any person holds fixed principal financial arrangements acquired in an income year in which the person
20 was a cash basis holder, income from those arrangements shall be calculated as if the person were a cash basis holder.

“(3) Notwithstanding subsection (1) of this section, where a cash basis holder holds fixed principal financial arrangements which that person acquired in an income year in which the
25 person was not a cash basis holder, income from those arrangements shall be calculated as if that person was not a cash basis holder.

“(4) For the purposes of subsection (1) of this section,—

30 “(a) All income from financial arrangements issued or acquired on or after the implementation date and assessable as trustees’ or beneficiaries’ income under sections 227 to 239 of this Act shall be disregarded, as shall the value of all such financial arrangements producing such income; and

35 “(b) Section 64c of this section shall apply to such trustees’ and beneficiaries’ income.

“(5) For the purposes of subsection (1) of this section—

“(a) Financial arrangements held; and

40 “(b) Income required to be returned from such arrangements under section 10 of this Act,—

by a partnership shall be treated as being held or, as the case may be, derived by each partner to the extent of the partner’s share in the partnership assets or, as the case may be, the income of the partnership from financial arrangements.

“**64E. Determinations**—(1) For the purposes of **section 64c** of this Act, the Commissioner may from time to time determine the following matters:

“(a) How the yield to maturity method shall be applied to any financial arrangement or class thereof within **section 64c (1)** (except the proviso thereto) of this Act: 5

“(b) The method for determining income or expenditure in relation to any financial arrangement or class thereof within **section 64c (2)** (except the proviso thereto) of this Act that results in the allocation to each income year of an amount that, having regard to the tenor of **section 64c (1)** of this Act, is fair and reasonable and reflects the taxpayer’s income or expenditure in relation to such financial arrangements: 10 15

“(c) The method or methods that may be applied in determining income or expenditure in relation to any class of financial arrangements pursuant to the provisos to **sections 64c (1) and 64c (2)** of this Act—

and any determination made under **paragraph (a) or paragraph (b)** of this subsection shall be followed by taxpayers for the purposes of **subsections (1) and (2) of section 64c** of this Act. 20

“(2) Where a person who issues or holds a financial arrangement, in respect of which the Commissioner has made a determination in accordance with **subsection (1)** of this section, is dissatisfied with the determination, the person may object to the determination by delivering or posting to the Commissioner, within one month after the date on which notice of the determination has been published or otherwise given by the Commissioner, a written notice of objection stating shortly the grounds of that person’s objection. 25 30

“(3) For the purposes of this section, Part III of this Act, excepting section 36, shall, in relation to any objection under this section, apply in the same manner and to the same extent as if the said objection were an objection made under **section 30 (1)** or, in the case of a late objection, **section 30 (2)** of this Act. 35

“(4) Where the Commissioner is satisfied that a determination made under **subsection (1)** of this section should be varied or rescinded, or restricted or extended in scope, he may from time to time make a fresh determination which shall be effective to vary, rescind, restrict, or extend the determination first mentioned in this subsection: 40

“Provided that no such fresh determination shall be required to be applied by any person in relation to financial arrangements acquired or issued by that person prior to the notification of or publication by the Commissioner of that
5 fresh determination.

“64F. **Income and expenditure where financial arrangement redeemed or disposed of**—(1) Notwithstanding **section 64c** of this Act, where, in relation to any person, a financial arrangement issued or acquired by the person on or after the
10 implementation date matures or is sold or otherwise transferred by the person in any income year, the amount of the base price adjustment in relation to that income year, that person, and that financial arrangement shall be an amount calculated in accordance with the following formula:

15
$$a - (b + c)$$

where—

- a is the amount of all consideration which has and will become payable to the holder or payable by the issuer in relation to the financial arrangement; and
- 20 b is the acquisition price of the financial arrangement in relation to that taxpayer; and
- c is all amounts treated as assessable income (other than income written off as a bad debt) or deductible expenditure of that taxpayer from that financial arrangement under **section 64c** of this Act in all previous
25 income years since the acquisition (in the case of a holder) or issue (in the case of an issuer) of the financial arrangement.

“(2) Where, in relation to a cash basis holder, a financial
30 arrangement acquired by that person on or after the implementation date matures, or is sold or otherwise transferred by that person in any income year, the amount of the cash base price adjustment in relation to that income year, that person, and that financial arrangement shall be an
35 amount calculated in accordance with the following formula:

$$a - (b + c)$$

where—

- a is the amount of all consideration derived in relation to the financial arrangement by the taxpayer; and
- 40 b is the acquisition price of the financial arrangement; and
- c is all amounts treated as assessable income of that person from that financial arrangement in all previous income years since the acquisition.

“(3) Subject to **subsection (5)** of this section, the amount of the base price adjustment in relation to any financial arrangement and any income year shall—

“(a) In relation to a holder,—

“(i) Where it is a positive amount, be deemed to be income derived by the holder in the income year; and

“(ii) Where it is a negative amount, be deemed to be an allowable deduction in calculating the assessable income of the holder in the income year: 10

“(b) In relation to an issuer—

“(i) Where it is a positive amount, be deemed to be expenditure incurred by the issuer in the income year; and

“(ii) Where it is a negative amount, be deemed to be income derived by the holder in the income year. 15

“(4) Subject to **subsection (5)** of this section, the amount of the cash base price adjustment in relation to any financial arrangement and any income year shall,— 20

“(a) Where it is a positive amount, be deemed to be income derived by the cash basis holder in the income year; and

“(b) Where it is a negative amount, be deemed to be an allowable deduction in calculating the assessable income of the cash basis holder in the income year. 25

“(5) The amount of any deduction allowable under **subsection (3)** or **subsection (4)** of this section to a holder (including a cash basis holder) in relation to a financial arrangement shall not exceed the amount of income derived or deemed to be derived from the financial arrangement by the holder, less any amounts written off as bad debts. 30

“64G. **Accrued income written off**—**Section 106 (1) (b)** of this Act shall apply to any amount of income calculated under **section 64c** of this Act but subsequently written off as if that amount were a bad debt. 35

“64H. **Inter-related arrangements**—Where a financial arrangement issued or acquired on or after the implementation date consists of 2 or more arrangements (such arrangements hereafter referred to in this section as related arrangements), all the persons who are party to that financial arrangement shall, in each year of its term, disclose to the Commissioner in the prescribed form and with each person’s annual return— 40

“(a) The existence of each of the related arrangements making up that financial arrangement and the parties thereto; and

5 “(b) The amount of assessable income or deductible expenditure of that person in respect of that financial arrangement; and

“(c) Such other information in relation to that financial arrangement or related arrangement as the Commissioner may require.

10 “64i. **Adjustments to estimated accruals of income and expenditure in respect of financial arrangements**—Where a person, in calculating that person’s income or expenditure in accordance with **section 64c** of this Act, has made an estimate of an amount payable or receivable at some future time or times,
15 then in the first income year in which the amount becomes known with certainty, if that amount differs from the estimated amount an adjustment shall be made in that first income year to the person’s assessable income.

“64j. **Financial arrangements not at arm’s length**—
20 (1) Where the Commissioner, having regard to any connection between the parties to the issue or transfer of a financial arrangement and to any other relevant circumstances, is satisfied that the parties were not dealing with each other at arm’s length in relation to the issue or transfer he may, for the
25 purpose of calculating the assessable income or expenditure of the parties under **section 64c** or **section 64f** of this Act, deem the consideration for the issue or transfer to be equal to the consideration that might reasonably be expected for the issue or transfer if the parties to the issue or transfer were
30 independent parties dealing at arm’s length with each other in relation to the issue or transfer:

“Provided that this section shall not apply to any disposition of trading stock to which **section 91** of this Act applies.

35 “(2) If at any time a person not resident in New Zealand—

“(a) Commences to hold, whether temporarily or otherwise, a financial arrangement for the purposes of a business carried on through a fixed establishment in New Zealand, the person shall be deemed to have acquired the financial arrangement at that
40 time:

“(b) Ceases to hold, whether temporarily or otherwise, a financial arrangement for the purposes of a business carried on through a fixed establishment in New Zealand, the person shall be deemed to

have disposed of the financial arrangement at that time—

and that acquisition or, as the case may be, that disposal shall, for the purposes of **subsection (1)** of this section, be deemed to be a transfer between parties that were not dealing with each other at arm's length in relation to the transfer.” 5

(2) Section 2 of the principal Act is hereby amended by inserting in the definition of the term “paid” (as inserted by section 3 (1) of the Income Tax Amendment Act 1983), after the words “any redemption payment”, the words “and to any financial arrangement as defined in **section 64B (1)** of this Act”. 10

(3) Section 65 (2) of the principal Act is hereby amended by inserting, after paragraph (ja) (as inserted by section 22 of the Income Tax Amendment Act 1978), the following paragraph: “(jb) Income derived or deemed to be derived under **sections 64c and 64f** of this Act:”. 15