Inland Revenue
Te Tari Taake

INTERPRETATION STATEMENT | PUTANGA WHAKAMĀORI

Deductions for parties to employee share schemes

Issued | Tukuna: 22 August 2024

IS 24/07

This interpretation statement considers what deductions employers can claim for income tax in relation to employee share schemes. It explains the need to satisfy the general permission and when the capital limitation might apply.

All legislative references are to the Income Tax Act 2007 unless otherwise stated.

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Introduction | Whakataki

1. The employee share scheme (ESS) tax regime changed in 2018. The objective of the changed rules is to treat ESS benefits neutrally so that, to the extent possible, whether remuneration for labour is paid in cash or shares the tax position does not change for either the employer or the employee.

2. Following the changes to the rules, we have received various questions about how the law applies in certain scenarios. This statement addresses some of those questions by explaining the rules for employer deductions and providing examples to illustrate how those rules apply.

3. This interpretation statement does not consider the implications of any anti-avoidance provisions and the outcomes set out may not apply where the general anti-avoidance provision (s BG 1) or the specific ESS anti-avoidance provision (s GB 49B) applies.

What is an employee share scheme?

4. Section CE 7 defines an ESS as follows:

CE 7 Meaning of employee share scheme

Employee share scheme means—

(a) an arrangement with a purpose or effect of issuing or transferring shares in a company (**company A**) to a person—

(i) who will be, is, or has been an employee of company A or of another company that is a member of the same group of companies as company A, if the arrangement is connected to the person's employment or service:

(ii) who will be, is, or has been a shareholder-employee in relation to company A or in relation to another company that is a member of the same group of companies as company A, if the arrangement is connected to the person's employment or service:

(iii) who is an associate of a person described in subparagraph (i) or (ii) (**person A**), if the arrangement is connected to person A's employment or service; but

(b) does not include an arrangement that—

(i) is an exempt ESS:

(ii) requires market value consideration to be paid by a person described in paragraph (a) for the transfer of shares in the company on the share scheme taxing date:

(iii) requires a person described in paragraph (a) to put shares, acquired by them for market value consideration, at risk, if the arrangement provides no protection against a fall in the value of the shares and none of the consideration for acquiring the shares is provided to the person under an agreement that it is used for acquiring the shares.

5. Broadly, an ESS is an arrangement:

- with a purpose or effect of issuing or transferring shares in a company to a person who will be, is, or has been an employee (or shareholder-employee) of that company or another company in the same group; and
- that is connected to the employee's (or shareholder-employee's) employment or service.

6. An employee and shareholder–employee are persons described in s CE 7(a)(i) and (ii) and are both referred to as the "employee" in this interpretation statement for ease of reference.

7. For the purposes of the Income Tax Act 2007 (Act), an "employee" is defined to include a person who receives or is entitled to receive a "PAYE income payment". This includes a payment of "salary or wages", "extra pay" or a "schedular payment". A "schedular payment" is a payment of a class set out in sch 4 of the Act, that in turn lists payments made to a wide variety of workers. Accordingly, the term "employee" for income tax purposes (and therefore the ESS rules) includes persons that are employees under

common law (ie under a contract of service) and, if they receive schedular payments, also persons that may be independent contractors under common law (ie under a contract for service). For more information on what constitutes an "employee" for tax purposes see IG 16/01: **Determining employment status for tax purposes (employee or independent contractor?**).

8. A common example of a person that might be an independent contractor at common law but an employee for income tax purposes because they receive schedular payments, and therefore are subject to the ESS rules, is a company director. For more discussion of when fees paid to directors are schedular payments, see IS 17/06: **Application of schedular payment rules to directors' fees** and IS 19/01: **Income tax – application of schedular payment rules to non-resident directors' fees**.

9. An ESS also includes providing shares to an associate of an employee (being a person described in s CE 7(a)(iii)) if the arrangement is in connection with the employee's employment or service. Accordingly, the person who might receive shares under an ESS could be either the employee or an associate. This interpretation statement refers to such a person as the "ESS beneficiary" (as also defined in s CE 7C).

10. An "arrangement" is defined in s YA 1 to mean "an agreement, contract, plan, or understanding, whether enforceable or unenforceable, including all steps and transactions by which it is carried into effect". It includes all aspects of a scheme, such as direct transfers of shares, loans to buy shares, bonuses, put and call options and transfers to trusts.

11. There are several potential parties to an ESS such as the employer, the ESS beneficiaries, the company issuing the shares (if different to the employer) and the trustee facilitating the scheme (if there is one). A person can be a party to an arrangement that is an ESS without necessarily being a signatory of the scheme's documents.

12. An amount derived by a person in connection with their employment or service is income under s CE 1(1)(d) if it is a benefit the person received under an ESS. The amount of the benefit is calculated on the share scheme taxing date (SSTD) using the formula in s CE 2(1). Regardless of whether the employee or an associate receives the shares or related rights, it is the employee that receives any employment income from the ESS as set out in s CE 1(1)(d) and s CE 2. This is because s CE 2(1) provides that a person who is described in s CE 7(a)(i) or (ii) (being the employee or the shareholder-employee) receives the benefit calculated under s CE 2 and therefore the income under s CE 1(1)(d).

13. Section CE 2 states:

> **CE 2 Benefits under employee share schemes**
>
> *Benefit*
>
> (1) A person who is an employee share scheme beneficiary described in section CE 7(a)(i) or (ii) receives a benefit for the purposes of section CE 1(1)(d) in relation to shares or related rights under the employee share scheme equal to the positive amount calculated on the share scheme taxing date using the formula—
>
> share value − consideration paid + consideration received − previous income.
>
> *Definition of items in formula*
>
> (2) In the formula in subsection (1),—
>
> (a) **share value** is the market value of the shares or related rights owned by an employee share scheme beneficiary on the share scheme taxing date, if the share scheme taxing date is not triggered by a transfer or cancellation of the shares or related rights:
>
> (b) **consideration paid** is the amount of consideration paid or payable by an employee share scheme beneficiary in relation to the transfer of the shares or related rights under the employee share scheme:
>
> (c) **consideration received** is the amount of consideration paid or payable to an employee share scheme beneficiary in relation to a transfer or cancellation of the shares or related rights under the employee share scheme, not including relevant shares or related rights under a replacement employee share scheme:
>
> (d) **previous income** is the total amount of income under section CE 1(1)(d) that the employee share scheme beneficiary has in relation to the shares or related rights before the date that is 6 months after the date of Royal assent for the Taxation (Annual Rates for 2017–18, Employment and Investment Income, and Remedial Matters) Act 2018 [Being 29 September 2018].
>
> …

14. Broadly, the amount of the employee's benefit under s CE 2(1) is the market value of the shares or related rights that an ESS beneficiary owns on the SSTD (or the amount of consideration paid or payable to an ESS beneficiary in relation to a transfer or cancellation of the shares or related rights) less any consideration provided by an ESS beneficiary. The SSTD, which is defined in s CE 7B, is essentially the date when:

- the shares are held by or for the benefit of an ESS beneficiary and there are no conditions or protections under the ESS that defer the date under s CE 7B(1)(a); or
- if the ESS beneficiary's rights are cancelled or transferred to a non-associate prior to this time, the date when that occurs under s CE 7B(1)(b).

Deductions for parties to an employee share scheme

15. Section DV 27 governs what deductions persons who are party to an ESS may take. The parties could potentially include, for example, the employer, the employees and (if different from the employer) the company issuing the shares. A trustee could also be facilitating the ESS, however a trustee is generally treated as nominee for the employer or company issuing the shares under s CE 6 (for more information regarding trustees of an ESS, see IS 24/04: **Trustee of employee share scheme trust treated as nominee**).

16. Section DV 27 states:

> **DV 27 Employee share schemes**
>
> *When this section applies*
>
> (1) This section applies when a person is party to an employee share scheme.
>
> *No deduction except as provided by this section*
>
> (2) Except as provided by this section, the person is denied a deduction for an amount of expenditure or loss for an income year incurred in relation to the employee share scheme.
>
> *Interest, establishment and management*
>
> (3) Subsection (2) does not apply to an amount of expenditure or loss to the extent to which the amount relates to—
>
> (a) a loan or interest:
>
> (b) establishing or managing the employee share scheme.
>
> *Deduction under section CE 2(3)*
>
> (4) The person is allowed a deduction for the amount of the deduction they are allowed under section CE 2(3) (Benefits under employee share schemes) for the income year.
>
> *Employment income*
>
> (5) The person is allowed a deduction for an amount of expenditure or loss incurred on employment income other than under section CE 1(1)(d) (Amounts derived in connection with employment).
>
> *Deduction for benefit*
>
> (6) If the person is the employing or contracting company for an employee share scheme beneficiary described in section CE 7(a)(i) or (ii) (Meaning of employee share scheme) (the **employee**), the person has an amount of expenditure or loss calculated using the formula in subsection (7).
>
> *Formula*

> (7) For the purposes of subsection (6), the amount of the expenditure or loss is the positive amount calculated using the formula—
>
> employee amount – previous deductions.
>
> *Definition of items in formula*
>
> (8) In the formula,—
>
> (a) **employee amount** is the amount for the employee calculated under the formula in section CE 2(1):
>
> (b) **previous deductions** is the total amount of deductions that have been allowed to a party to the employee share scheme or an associate for expenditure or loss incurred—
>
> (i) in relation to the employee amount; and
>
> (ii) before the date that is 6 months after the date of Royal assent for the Taxation (Annual Rates for 2017–18, Employment and Investment Income, and Remedial Matters) Act 2018.
>
> *Income*
>
> (9) A negative amount calculated using the formula in subsection (7) is an amount of income of the person.
>
> *Link with subpart DA*
>
> (10) Subsection (4) supplements the general permission. Subsection (4) overrides the employment limitation.

17. As set out in s DV 27(2), a party to an ESS is denied a deduction for any expenditure relating to ESS except as provided for by s DV 27. For example, expenditure to acquire shares (including related legal and brokerage fees) for the purposes of the ESS is not deductible as it is not provided for in s DV 27.

18. Section DV 27(3) provides that subs (2) does not apply to an amount of expenditure to the extent that it relates to a loan or interest, or establishing or managing the ESS. This means deductions for that expenditure may still be available in accordance with ordinary principles.

19. An employer is also allowed a deduction under s DV 27(5) for expenditure on employment income that is not a benefit under an ESS. For example, this might include the payment of a bonus that is used by the employee to subscribe for shares.

20. Section DV 27(6) provides that an employer has an amount of expenditure or loss for an employee as calculated under s DV 27(7). Under s DV 27(7), the amount of the "expenditure" is calculated by reference to the employee's benefit and does not involve an outlay by the employer in the normal sense. This subsection only applies to the employer and not to any other party involved in the ESS. For example, it does not

apply to a group company issuing the shares under the ESS if that company is not the employer. Expenditure or loss under s DV 27(6) is explained further from [26].

21. Section DV 27 also addresses where a deduction might be available for the employee as a party to an ESS. An employee may have a deduction under s DV 27(4) where an ESS beneficiary has paid more than the market value of the shares on the SSTD.

22. Usually, a person is allowed a deduction for an amount of expenditure or loss to the extent that it meets the general permission in s DA 1. The six general limitations set out in s DA 2 override the general permission and the result can be that expenditure that meets the general permission is not deductible.

23. However, some provisions in the Act supplement the general permission or override a general limitation. Section DA 3 describes how specific rules in Part D affect the general rules. In summary, a provision in Part D may supplement the general permission, meaning that it is not necessary to satisfy the general permission, by expressly stating that it is supplementing the general permission. However, the general limitations may still apply unless the provision expressly overrides them. If a provision in Part D is to override the general permission and/or any one or more of the general limitations, the provision must expressly state that it does so.

24. For items of expenditure or loss referred to in s DV 27, only the potential deduction for employees under s DV 27(4) supplements the general permission and overrides one of the general limitations (the employment limitation). This is expressly provided for in s DV 27(10). None of the other items of expenditure or loss referred to in s DV 27 supplements the general permission or overrides any general limitations.

25. See [32] to [47] for more information on the general permission and general limitations.

Employer treated as having expenditure or loss under s DV 27(6)

26. Section DV 27(6) provides that the "employing or contracting company" in respect of the employee has an amount of expenditure or loss as calculated under s DV 27(7). As set out in [7] above, the term "employee" for income tax purposes (and therefore the ESS rules) includes persons that are employees under common law and, if they receive schedular payments, also persons that may be independent contractors under common law. The reference to the employing **or** contracting company in s DV 27(6) ensures that regardless of the person's employment status at common law, if they are an "employee" for tax purposes, the employing company (for an employee at common law) or contracting company (for an independent contractor at common law) has

expenditure or loss under the ESS rules. For ease of reference, this interpretation statement generally refers to the employing or contracting company as the employer.

27. The amount of expenditure or loss under s DV 27(6) is equal to the positive amount calculated in accordance with the following formula in s DV 27(7):

employee amount – previous deductions

28. The terms used in the formula are defined in s DV 27(8) as follows:

- "Employee amount" is the amount for the ESS beneficiary calculated under the formula in s CE 2(1). Section CE 2(1) (ie calculation of the employee's benefit) is set out and discussed from [12] to [14].
- "Previous deductions" is the total amount of deductions that have been allowed to a party to the ESS or an associate for expenditure or loss incurred in relation to the employee amount on or before 29 September 2018 (which is the date that is 6 months after the amending legislation was enacted). This element of the formula will become less relevant over time.

29. Accordingly, an employer's expenditure or loss under s DV 27(6) is linked to the amount of the employee's benefit as both use the formula in s CE 2(1) as an element in their respective calculations.

30. The result of s DV 27(6) and (7) is that an employer is treated as incurring an amount of expenditure that is generally equal to the amount of the employee's benefit. The formula provided in s DV 27(7) is not dependent on the employer incurring any expenditure in the ordinary sense. Accordingly, the employer does not incur any expenditure in the way it does when it pays salaries and wages. The amount of expenditure or loss may arise for the employer even when a different member of the group is the one issuing shares under the ESS.

31. Example | Tauira 1 illustrates the situation where a New Zealand parent issues shares to employees of a foreign subsidiary. Example | Tauira 2 illustrates the situation where a foreign parent issues shares to employees of a New Zealand-resident employer.

Example | Tauira 1 – New Zealand parent issues shares to employees of foreign subsidiary

Parent Co is a New Zealand resident company that makes widgets. It has a wholly owned subsidiary in the Philippines which operates a call centre. The employees of the subsidiary can qualify for shares in Parent Co under the group's ESS. No consideration is paid by the employees when shares are issued.

Parent Co is a party to an ESS and therefore its deductions in respect of the ESS are subject to s DV 27. While Parent Co issues shares under the terms of the ESS, it does

not have an amount of expenditure or loss under s DV 27(6) for the benefits provided to the employees in the offshore subsidiary as it is not the employer. If it has expenditure or loss relating to a loan or interest or establishing or managing the ESS, it may have deductions under ordinary principles.

As the employer, the subsidiary in the Philippines could have an amount of expenditure or loss under s DV 27(6). However, as the benefits are not provided to the employees in the course of the subsidiary deriving assessable or excluded income in New Zealand, s DA 1 would not be satisfied and the amount would not be deductible.

Example | Tauira 2 – New Zealand employees receive shares in foreign parent

Employer Co is a wholly owned New Zealand subsidiary of Parent Co, a company resident in the United Kingdom. Employer Co sells mulching machines and gutter guards in New Zealand.

The group has an ESS where the New Zealand resident employees of Employer Co are issued shares in Parent Co when they meet certain conditions, such as continued employment with Employer Co for 3 years.

Employer Co is a party to an ESS and is the employer. While Employer Co does not issue shares or make any payments under the terms of the ESS, it has expenditure or loss under s DV 27(6) calculated under s DV 27(7) when its employees receive shares from Parent Co. That amount will be deductible under s DA 1 as Employer Co incurs it in carrying on its business to derive assessable income and none of the general limitations in s DA 2 applies. If the New Zealand employees performed services for Parent Co, Employer Co will need to consider whether any transfer pricing adjustments are required.

Amount must be deductible under ordinary principles

32. As explained from [22] to [24], s DV 27(6) does not supplement the general permission or override any general limitations for employers. Accordingly, while s DV 27(6) deems the employer to have an amount of expenditure or loss as calculated under the formula in subs (7), the employer must still satisfy the general permission in s DA 1 and not be subject to the general limitations in s DA 2 to obtain a deduction for that deemed expenditure or loss.

33. Section DA 1 states:

> **DA 1 General permission**
>
> *Nexus with income*
>
> (1) A person is allowed a deduction for an amount of expenditure or loss, including an amount of depreciation loss, to the extent to which the expenditure or loss is—
>
> (a) incurred by them in deriving—
>
> (i) their assessable income; or
>
> (ii) their excluded income; or
>
> (iii) a combination of their assessable income and excluded income; or
>
> (b) incurred by them in the course of carrying on a business for the purpose of deriving—
>
> (i) their assessable income; or
>
> (ii) their excluded income; or
>
> (iii) a combination of their assessable income and excluded income.
>
> *General permission*
>
> (2) Subsection (1) is called the general permission.

34. Section DA 1(1)(a) provides for the deductibility of expenditure that is incurred in deriving assessable income (or excluded income, or a combination of the two). Section DA 1(1)(b) provides for the deductibility of expenditure incurred in the course of carrying on a business for the purpose of deriving assessable income (or excluded income, or a combination of the two).

35. The first limb therefore requires a nexus with the deriving of assessable or excluded income, and the second requires a nexus with the carrying on of a business. The nexus, or degree of connection, required to satisfy each of the two limbs of deductibility is the same, although it is measured in different contexts, namely non-business and business (*NRS Media Holdings v C of IR* (2018) 28 NZTC 30,328).

36. It is a matter of degree, and so is a question of fact, to determine whether a sufficient relationship exists between the expenditure and the derivation of income, or the carrying on of a business for the purpose of deriving income. The phrase "the occasion of the loss or outgoing should be found in whatever is productive of the assessable income" is helpful in both characterising the factual inquiry that the application of the statutory language requires and describing the nexus that is the focus of that inquiry (*CIR v Banks* (1978) 3 NZTC 61,236 (CA), *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271 (CA), *NRS Media Holdings*, *Ronpibon Tin NL v FCT* (1949) 78 CLR 47).

37. In the context of expenditure or loss that s DV 27(6) effectively deems to be incurred for an amount calculated under s DV 27(7), there is no item of expenditure that can be examined in the way a usual outlay can. We consider that it must be determined whether a sufficient relationship exists between the provision of the benefit to the employee under the ESS (which is what gives rise to the deemed expenditure) and the derivation of the employer's income.

38. Example | Tauira 3 illustrates how the relationship between the provision of the benefit to the employee and the derivation of the employer's income might be considered in the context of a secondment.

Example | Tauira 3 – Employee seconded to group company

Base facts

A company incorporated in New Zealand (NZ Co) manufactures and sells widgets in New Zealand. It also exports widgets to Australia. NZ Co's sister company incorporated in Australia (Aus Co) imports the widgets and sells them in the Australian market. The group is ultimately owned by a company incorporated in the United Kingdom (Parent Co). The group has an employee share scheme that employees of the group are eligible to participate in to acquire shares in Parent Co. A trustee of the group's employee share scheme trust facilitates the transfers of the shares.

On 15 June 2021, the trustee acquires 1,000 shares in Parent Co worth $1,000 to hold on trust for an employee of the group. If the employee leaves the group for any reason during the next 3 years (the performance period), the shares are forfeited for no consideration. If the employee is still employed by the group on 15 June 2024, the shares are transferred to them. The shares are worth $3 per share on 15 June 2024. The employee does not provide any consideration for the shares.

Scenario 1

The employee lives and works in New Zealand and is employed by NZ Co in the New Zealand sales force. An opportunity arises to be seconded to Aus Co to work in the Australian sales force to learn and share different sales techniques. On 15 June 2023, the employee is seconded to Aus Co for a 3-month period. The employee continues to be employed, paid and managed by NZ Co. Aus Co pays NZ Co an appropriate fee for the services of the employee over the secondment, which is returned as income by NZ Co for New Zealand tax purposes.

The employee's ESS benefit for the year ending 31 March 2025 is $3,000 (being 1,000 shares in Parent Co with a market value of $3 per share).

As the employer, NZ Co has expenditure or loss under s DV 27(6) in the year ending 31 March 2025 of $3,000. NZ Co is allowed a deduction for this expenditure because

the employment has a sufficient nexus with NZ Co's income over the 3-year performance period – mostly in deriving income from the business of New Zealand widget sales and a small portion in the third year in deriving income from providing its employee's services. In this respect, where transactions are taking place cross-border between group companies, transfer pricing adjustments may be relevant.

Scenario 2

The employee lives and works in Australia and is employed by Aus Co in the Australian sales force. An opportunity arises to be seconded to NZ Co to work in the New Zealand sales force to learn and share different sales techniques. On 15 June 2023, the employee is seconded to NZ Co for a 3-month period. The employee continues to be employed, paid and managed by Aus Co. NZ Co pays Aus Co an appropriate fee for the services of the employee over the secondment, which is deductible by NZ Co for New Zealand tax purposes as it is incurred in the course of its New Zealand sales activity.

The employee's ESS benefit for the year ending 31 March 2025 is $3,000 (being 1,000 shares in Parent Co with a market value of $3 per share).

As the employer, Aus Co has expenditure or loss under s DV 27(6) in the year ending 31 March 2025 of $3,000. However, as Aus Co does not derive assessable or excluded income in New Zealand, the provision of the benefit to the employee does not have any nexus to the derivation of Aus Co's income in New Zealand, meaning s DA 1 would not be satisfied and the amount would not be deductible to Aus Co in New Zealand.

NZ Co is not the employer. Instead, it is paying Aus Co for the services of the employee for the 3-month period of the secondment (and is deducting that expenditure for New Zealand tax purposes). Accordingly, NZ Co is not a person that has any additional expenditure or loss under s DV 27(6) for the benefit provided to Aus Co's employee.

Alternative scenarios

The above scenarios involve facts where the employer does not change because of the secondment. In some situations, a secondment may result in there being a different employer, or perhaps more than one employer, during the term of secondment. In such situations, s DV 27(6) may apply differently to what is set out above. The facts of each case must be considered.

39. If an amount of expenditure or loss satisfies the general permission, in order to be deductible it must also not be subject to any of the general limitations in s DA 2 because they override the general permission. Section DA 2 states:

DA 2 General limitations

Capital limitation

(1) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is of a capital nature. This rule is called the capital limitation.

Private limitation

(2) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is of a private or domestic nature. This rule is called the private limitation.

Exempt income limitation

(3) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is incurred in deriving exempt income. This rule is called the exempt income limitation.

Employment limitation

(4) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is incurred in deriving income from employment. This rule is called the employment limitation.

Withholding tax limitation

(5) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is incurred in deriving non-resident passive income of the kind referred to in section RF 2(3) (Non-resident passive income). This rule is called the withholding tax limitation.

Non-residents' foreign-sourced income limitation

(6) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is incurred in deriving non-residents' foreign-sourced income. This rule is called the non-residents' foreign-sourced income limitation.

Relationship of general limitations to general permission

(7) Each of the general limitations in this section overrides the general permission.

40. In the context of an ESS, the "capital limitation" set out in s DA 2(1) that denies a deduction to the extent the expenditure or loss is of a capital nature may be the most relevant general limitation. We discuss the capital limitation in more detail from [41].

The distinction between capital and revenue expenditure

41. Two general principles form the basis for the distinction between capital and revenue expenditure. Dixon J formulated these principles in *Hallstroms Pty Ltd v FCT* (1946) 72 CLR 634 (HCA) at 647 and 648:

> … the contrast between the two forms of expenditure corresponds to the distinction between the acquisition of the means of production and the use of them; between

> establishing or extending a business organization and carrying on the business; between the implements employed in work and the regular performance of the work in which they are employed; between an enterprise itself and the sustained effort of those engaged in it.
>
> ….
>
> What is an outgoing of capital and what is an outgoing on account of revenue depends on what the expenditure is calculated to effect from a practical or business point of view rather than on the juristic classification of any legal rights secured, employed or exhausted in the process.

42. In *Commissioner of Taxes v Nchanga Consolidated Copper Mines* [1964] AC 948, the Privy Council applied the distinction between capital and revenue drawn in *Hallstroms*. Viscount Radcliffe stated at 960:

> Again courts have stressed the importance of observing a demarcation between the cost of creating, acquiring or enlarging the permanent (which does not mean perpetual) structure of which the income is to be the produce or fruit and the cost of earning that income itself or performing the income earning operations. Probably this is as illuminating a line of distinction as the law by itself is likely to achieve …

43. Various cases have considered whether employee-related costs are of a revenue or capital nature. For example, in *Christchurch Press Co Ltd v C of IR* (1993) 15 NZTC 10,206, wages paid to electricians and engineers for installing a printing press were held to be capital in nature and non-deductible. This case shows there is no presumption of symmetry between income and deductions.

44. More recently, in *Clough Ltd v FC of T (No 2)* 2021 ATC 24,801, the Full Federal Court of Australia held that payments to cancel share entitlements of employees arising from a takeover were of a capital nature. This was because, after applying conventional capital / revenue principles, the Court found the occasion of the payments lay in the takeover and the object behind making the payments was the bringing to an end of the employees' rights to facilitate the takeover.

45. It is uncertain if a New Zealand court would follow the *Clough* decision for the following reasons:

    - New Zealand's ESS tax rules are different to Australia. Australia does not have an equivalent to s DV 27(6). In Australia, if an employer issues shares to an employee no expenditure arises because the employer does not incur any cost – only its share capital is diluted (as noted in *Clough*). In New Zealand, the employer is treated as incurring an amount of expenditure that is generally equal to the amount of the employee's benefit under s DV 27(6).
    - The underlying purpose of the ESS rules in New Zealand is that employers and employees should be neutral as far as possible regardless of whether the

remuneration is in the form of cash or shares. In New Zealand, if an employer is entitled to deduct the cost of shares issued on an early vesting event (such as a share sale), a cash equivalent payment in lieu of the shares should also be deductible.

- *Clough* was decided on its specific factual circumstances. The Full Federal Court found there was no evidence that the cancellation payments were to reward employees.

46. As a general principle, if there is evidence that an ESS cancellation payment is to meet an existing obligation owed to employees for past employment services (that are revenue in nature), the payment is revenue in nature. This is the case even if the event crystallising the payment arises from a capital transaction, such as a sale of shares or a business where the terms of the ESS provide for an accelerated vesting on a liquidity event (such as a change of control). However, the revenue outcome is less certain if the terms of the ESS do not provide for a liquidity event, as the employer is not obliged to make the cancellation payment. Case law that demonstrates this general principle (including that set out above) is discussed in more detail in the Appendix.

47. Example | Tauira 4, Example | Tauira 5 and Example | Tauira 6 illustrate how the capital limitation might (or might not) apply in certain scenarios. In any case, the answer will depend on a close examination of the facts and the character of the particular benefit or payment to establish the nature and purpose or effect of the relevant expenditure. Variations or additions to the facts in the examples may give rise to a different answer.

Example | Tauira 4 – Share sale – accelerated vesting and issue of shares

Base facts

On 1 May 2023, Employer Co issues 5 employees 1,000 share options each under an ESS option plan as part of a long-term incentive scheme implemented for retention purposes.

The options may be exercised at the earlier of 1 May 2026 (after 3 years of employment) and the date of a liquidity event, if the employees remain employed by Employer Co at that date (vesting date).

A liquidity event includes a change of control such as a sale of Employer Co's business or a sale by the shareholders of all the shares in Employer Co.

On the vesting date, the employees can each exercise the 1,000 options and buy 1,000 of Employer Co shares for $1 per share.

The options will lapse if they are not exercised by the employees.

The option plan does not contain a cash-out mechanism.

A share sale requiring an option plan to be wound up

On 1 May 2024, the shareholders of Employer Co agree to sell 100% of their shares to the third-party buyer on 2 April 2025. The sale and purchase agreement provides that any unvested options of employees must be cancelled before settlement.

The sale triggers a liquidity event and the options vest. The 5 employees exercise the options on 1 April 2025 and each acquires 1,000 shares at $1 each. Their shares are sold to the buyer on 2 April 2025.

The share price of Employer Co is $3 per share on 1 April 2025.

The ESS income arising to each employee on exercise of the options is $2,000 each ($3,000 share value less $1,000 cost). The total ESS income to 5 employees is $10,000.

Employer Co has $10,000 of deemed expenditure (s DV 27(6)).

The capital limitation in s DA 2(1) is unlikely to apply to Employer Co for the $10,000 expenditure for the following reasons:

- Although the sale of the shares triggers an early vesting of the options, Employer Co's obligation to issue shares to the employees for $1 each arises by reason of employment of the employees until the liquidity event, and the delivery of the shares in fulfilment of that obligation will be revenue in character.
- That obligation existed before the sale of Employer Co's shares, and the option plan incentivises employees to stay employed with Employer Co for at least 3 years (or until a liquidity event occurs).

Example | Tauira 5 – Share sale – cancellation payment

The same **base facts** as set out in Example | Tauira 4 apply. However, instead of an early vesting and issue of shares, a cancellation payment is made.

On 1 May 2024, the shareholders of Employer Co agree to sell 100% of their shares to a third-party buyer. The sale will settle on 2 April 2025. The sale and purchase agreement requires the shareholders to procure Employer Co to cancel the 5 employees' share options on 1 April 2025.

One of the employees assists with the sale process by compiling financial information in response to due diligence requests in addition to their normal employment duties.

The share price of Employer Co is $3 per share on 1 April 2025.

Employer Co offers to cancel the employees' options for a cash payment of $2,000 to each of them ($10,000 in total) on 1 April 2025.

The offer letter states that the cash payment is to meet the Employer Co's obligations under the option plan and is in recognition of past normal employment duties.

The employees accept the offer, Employer Co pays them $10,000 on 1 April 2025 and the options are cancelled.

The capital limitation in s DA 2(1) is unlikely to apply to Employer Co for the $10,000 payment for the following reasons:

- Although the sale and purchase agreement requires cancellation of the option plan and the sale of the shares triggers the cancellation payment, Employer Co's obligation to make the payment arises by reason of employment of the employees until the liquidity event.
- The cancellation payment is in recognition of past normal employment duties.
- The employee's involvement in the sale process does not change the nature of the cancellation payment. This is because the cancellation payment is not paid for assisting with the sale process. The employee is receiving the same ESS benefit as employees who do not assist with the sale process. However, if the employee received an additional amount for assisting with the sale process the additional amount may be capital in nature.

The same outcome should arise if a cancellation payment arises from an asset sale in similar circumstances.

Example | Tauira 6 – Options issued for capital project

On 1 May 2023, Employer Co issues 2 employees 1,000 share options each under an ESS option plan to incentivise them while working on an internal capital project for three years.

The options may be exercised at the earlier of 1 May 2026 (after 3 years of employment) and the date of a liquidity event, if the employees remain employed by Employer Co at that date (vesting date).

On the vesting date, the employees can each exercise the 1,000 options and buy 1,000 of Employer Co shares for $1 per share.

The capital project finishes on 1 May 2026. The employees exercise their options on 1 May 2026 and acquire shares on the same day.

The share price of Employer Co is $3 per share on 1 May 2026.

For the period 1 May 2023 to 1 May 2026, Employer Co has capitalised the cost of the 2 employees' salaries to the capital project and has not claimed an income tax deduction for the salaries (other than as part of the cost base for the capital project).

The ESS income arising to each employee on exercise of the options is $2,000 each ($3,000 share value less $1,000 cost). The total ESS income to 2 employees is $4,000.

Employer Co has $4,000 of deemed expenditure (s DV 27(6)).

The capital limitation in s DA 2(1) is likely to apply to Employer Co for the $4,000 deemed expenditure for the following reasons:

- The options were granted to employees for working on a capital project.
- The employment services performed by the employees during the vesting period related to a capital project.
- The outcome is similar to *Christchurch Press Co Ltd v C of IR* (1993) 15 NZTC 10,206.

Relationship between employer's expenditure and employee's benefit

48. As set out from [26] to [30], the employer's expenditure or loss calculated under s DV 27(6) to (8) is linked to the amount of the employee's benefit. This is because the formula for calculating the amount of expenditure or loss is the employee amount (being the benefit calculated under the formula in s CE 2(1)) less previous deductions (being deductions allowed for expenditure or loss incurred in relation to the employee's benefit before the reformed rules came into force – ie 29 September 2018). Deductions under the former rules will over time be used up, such that the employer's expenditure or loss under s DV 27(6) will equal the employee's benefit under s CE 2(1) in amount.

49. While the amount of the employer's expenditure or loss under s DV 27(6) is obviously linked to the amount of the employee's benefit under s CE 2(1), whether the expenditure or loss is deductible to the employer is not linked to whether the benefit is assessable to the employee.

50. The amount of the employer's deduction may be different to the amount of the employee's assessable income because the employer's expenditure or loss under s DV 27(6) is subject to the general permission and general limitations. This may result in apportionment or denial of a deduction. What is relevant to the employer's

deduction is the nexus the provision of the benefit has with the employer's assessable or excluded income (as discussed from [32] to [40]).

51. In contrast, the employee's benefit calculated in s CE 2(1) is income under s CE 1(1)(d), and subject to the usual criteria to determine whether it is assessable income under s BD 1. For instance, if it is non-residents' foreign-sourced income, it will not be assessable income under s BD 1(5)(c). This is demonstrated by s CE 2(5), which applies to apportion some or all of the benefit to non-residents' foreign-sourced income where the employee has been non-resident while earning the benefit.

52. This treatment is consistent with the underlying policy of the ESS rules that employers and employees should be neutral as far as possible regardless of whether the remuneration is in the form of cash or shares. If an employer paid cash to a non-resident employee, the expense would be deductible (subject to the general permission and general limitations) even though the amount may not be taxable to the employee in New Zealand. Example | Tauira 7 illustrates situations where a company has a non-resident employee.

Example | Tauira 7 – Employer deduction does not depend on whether the employee benefit is assessable

Base facts

Employer Co is a New Zealand resident. It exports to Japan and has an employee to provide after-sales assistance to customers.

On 15 June 2021, Employer Co transfers 1,000 shares worth $1,000 to a trustee on trust for the employee. If the employee leaves Employer Co for any reason during the next 3 years, the shares are forfeited for no consideration. If the employee is still employed by Employer Co on 15 June 2024, the shares are transferred to them. The shares are worth $3 per share on 15 June 2024. The employee does not provide any consideration for the shares.

Scenario 1

The employee lives in Osaka and is not tax resident in New Zealand. They provide the after-sales assistance from their home in Japan.

The employee's income in the year ending 31 March 2025 is $3,000 (being 1,000 shares with a market value of $3 per share). However, as the employee is not tax resident in New Zealand and performs their services outside of New Zealand, all the income is non-residents' foreign-sourced income and is not taxed in New Zealand.

As the employer, Employer Co has expenditure or loss under s DV 27(6) in the year ending 31 March 2025 of $3,000. Employer Co is allowed a deduction in respect of this

expenditure because the employment has a sufficient nexus with Employer Co's export business, which satisfies the general permission. This is the case even though the employee has no income tax liability in New Zealand.

Scenario 2

The employee is resident in New Zealand and provides the after-sales assistance from Employer Co's office in Auckland. On 15 June 2023, the employee moves to Japan and ceases to be tax resident in New Zealand. The employee continues providing after-sales assistance to customers from their residence in Japan. This means that the employee is New Zealand resident for 2 of the 3 years of service, and then non-resident for the last year.

The employee's income in the year ending 31 March 2025 is $3,000 (being 1,000 shares with a market value of $3 per share). However, only $1,000 of the employee's income is non-residents' foreign-sourced income and is not taxed in New Zealand. The employee will be taxable on the remaining $2,000 of ESS benefits subject to the terms of the tax treaty between Japan and New Zealand.

As the employer, Employer Co has expenditure or loss under s DV 27(6) in the year ending 31 March 2025 of $3,000. Employer Co is allowed a deduction for this expenditure because the employment has a sufficient nexus with Employer Co's export business, which satisfies the general permission. This is the case even though only a portion of the benefit is taxable in New Zealand to the employee.

Negative amount income for the employer

53. If the result of the formula in s DV 27(7) is negative, income arises for the employer under s DV 27(9). Section CV 20 affirms that income under s DV 27(9) is income of the employer. The result of the formula may be negative if, for example:

    - the employee provides more consideration for the shares than their market value on the SSTD; or
    - the employer has deducted more than the employee amount in respect of the benefit on or before 29 September 2018.

Timing of an employer's expenditure or loss under s DV 27(6), or income under s DV 27(9)

54. The timing of an employer's expenditure or loss under s DV 27(6) or income under s DV 27(9), and whether it arises on the SSTD or 20 days later on the "ESS deferral date", is considered in QB 21/04: **When an employer is party to an employee share**

scheme, when does an employer's expenditure or loss under s DV 27(6) or income under s DV 27(9) arise?

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CIR v Banks (1978) 3 NZTC 61,236 (CA)

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Appendix

55. As noted at [46], the Commissioner's view is that a payment to meet an existing obligation owed to employees for past employment services (that are revenue in nature) is revenue in nature even if the event crystallising the payment arises from a capital transaction. This appendix provides further analysis of the cases that are discussed in determining when the capital limitation might apply to prevent the deductibility of payments made under an ESS. The analysis first considers the Australian decision in *Clough* and then explores other case law in more detail.

Clough

56. In *Clough*, the Full Federal Court of Australia held that payments to terminate existing share entitlements (shares and options) of employees to facilitate a takeover of Clough were capital in nature and not deductible by the employer. There was no evidence that the payments were to reward employees.

57. To attract and retain employees, Clough implemented an option plan and an incentive scheme. If employees met certain performance criteria, the option plan entitled them to receive shares. The incentive scheme entitled employees to receive shares or cash at Clough's discretion after 3 years.

58. Clough was listed on the Australian stock exchange. Murray and Roberts (M&R), the majority shareholder in Clough, wanted to acquire all the shares in Clough through a scheme implementation agreement (SIA). The proposed acquisition meant that the rights in the option plan and incentive scheme had to end. Employees could not hold shares in Clough if M&R's objective was to own 100% of Clough.

59. Under the option plan, a change of control event (such as M&R's acquisition of the Clough shares from the minority shareholders) allowed the board to declare that the options could vest immediately even if the performance criteria were not met. Under the incentive scheme, the employees' rights to receive shares or cash would vest automatically under the change of control event (even if the employees did not meet the 3-year vesting period).

60. Both Clough and M&R assumed there was an obligation to pay employees for the accrued entitlements they held in the option plan and incentive scheme. The SIA required Clough to use its best endeavours to cancel options and rights held by employees. (The alternative to cancelling was to allow the options and rights to vest early under the option plan and incentive scheme, enabling employees to acquire shares for sale to M&R under the SIA.)

61. Clough made offers to all its employees (outside of the terms of the option plan and incentive scheme) to cancel their options and rights based on a calculation of what

their options and rights would be if they vested immediately under the prevailing share price. The offers were conditional on the SIA becoming effective. The employees accepted the offer.

62. The SIA was implemented on 11 December 2013. The options and rights were cancelled on that day, payments totalling approximately A$15 million were made to employees, M&R acquired the minority shareholding in Clough, and Clough was delisted from the Australian stock exchange.

63. The Full Federal Court of Australia held the payments were capital in nature, and not incurred in gaining or producing assessable income (nor in carrying on a business for the purpose of doing so) under the general deductibility provisions of the Australian Income Tax Assessment Act 1997 (Cth). This was because the occasion for the expenditure lay in the corporate takeover and not in gaining or producing assessable income and were not in the nature of a working expense in the carrying on of the taxpayer's business. The payments were made to facilitate a takeover to secure 100% ownership by M&R, and were not directed to retaining or incentivising employees. Thawley J stated at [18]:

> 18. Questions of characterisation are ones about which minds often differ. The difficulty this case presents is that the payments were made both to facilitate a change in control of Clough and also to honour legal or commercial obligations to employees arising out of the fact that Clough had granted options and rights to its employees in the course of running its business and for the purpose of rewarding and incentivising those employees. For the reasons which follow, in a practical business sense, the payments are better characterised as payments made pursuant to an agreement to secure a change in control rather than as meeting employee entitlements on a change of control … The rights were granted to the employees in gaining or producing assessable income. However, the occasion of the outgoings lay in the takeover and the object behind making the payments was the bringing to an end of the employees' rights, at the one time, to facilitate the takeover by Murray & Roberts and the delisting of Clough.

64. From [87] to [92], Thawley J concluded the payments were capital in nature for the following reasons:

- The immediate advantage that Clough sought by making the payments was to bring the various options and rights to an end permanently. The object in making payments was to complete M&R's takeover of the minority shareholding in Clough.
- The bringing of the options and rights to an end had an effect on the capital structure of Clough by removing the options and rights as securities on issue.
- Clough cancelled the obligations and rights in performance of its obligations under the SIA.

- As far as Clough was concerned, the payments were all made at once to secure one enduring change: namely, Clough would become wholly owned by M&R.
- The payments were calculated by reference to the share price, not by reference to time that particular employees had served or by reference to performance criteria they had achieved. The payments were unusual and not in the nature of an ordinary working expense.

Other case law on employee-related costs

65. The cases below are relevant to the deductibility of employee-related costs. Some of the foreign cases relating to the transfer of employee leave is specifically overridden by New Zealand statute (eg s DC 10). However, the cases demonstrate general principles such as payments to meet existing obligations owned to employees are generally revenue in nature (if the services provided by employees are revenue in nature).

66. In *Heather (I of T) v PE Consulting Ltd* (1972) 48 TC 293, an employer paid contributions into an employee share trust. The court held the payments were revenue in nature because the scheme provided an incentive for staff to remain employed and it helped recruit new staff. This helped the business run more efficiently.

67. Both *CIR (Hong Kong) v Cosmotron Manufacturing Co Ltd* [1997] STC 1,134 (Privy Council) and *FC of T v Foxwood (Tolga) Pty Ltd* (1981) 35 ALR 1 (High Court of Australia) support the principle that expenditure incurred to meet existing obligations owed to employees is revenue in nature, even if the event crystallising the payment occurs after the business has ceased, or arises from the sale of a business. This is relevant for an ESS if a change of control event (such as a share or asset sale) triggers an accelerated vesting of the ESS benefits.

68. In *Cosmotron*, the Privy Council held that the employer always had an obligation to make severance payments to staff. It did not matter that the payment was triggered by the closure of the business. The purpose of the payment was to employ staff because severance benefits were a necessary condition of inducing staff to work for the taxpayer. Therefore, it was revenue in nature.

69. In *Foxwood*, the High Court of Australia held that a payment by the vendor (taxpayer) of a business to the purchaser to take on accrued holiday pay of employees was deductible by the taxpayer, as the taxpayer was liable for the employees' holiday pay at the time the business was sold. However, the taxpayer could not deduct a payment for accrued long-service leave, as it was not liable to the employees for that amount.

70. A discretionary bonus paid on the retirement of a reporter was held to be revenue in nature and deductible in *Smith v Incorporated Council of Law Reporting for England and Wales* (1914) 6 TC 477. There was an expectation the bonus would be paid, and it meant the employer could pay the reporter a smaller salary during their working life.

71. *Maryborough Newspaper Co Ltd v FC of T* (1929) 43 CLR 450 involved the taxpayer paying a 10-year annual pension to induce an editor of a newspaper to resign. The payment was held to be deductible as a revenue expense. Such payments ensured loyalty and efficiency in the newspaper business. The taxpayer realised that treating the editor unfairly could cause newspaper circulation to drop and discourage others from applying for the editor's job.

72. The following are examples of non-deductible expenditure:

- In *Christchurch Press Co Ltd v C of IR* (1993) 15 NZTC 10,206, wages paid to electricians and engineers for installing a printing press were held to be capital in nature and non-deductible. This case shows there is no presumption of symmetry between income and deductions.
- In *CIR v New Zealand Forest Research Institute Limited* (2000) 19 NZTC 15,690 (Privy Council), the taxpayer purchased a business and agreed to assume accrued annual leave entitlements of employees transferred as a reduction in the purchase price of the business. The subsequent payment of the leave by the taxpayer to employees was held to be non-deductible capital expenditure. There are now specific rules on the deductibility of accrued leave.
- In *Commrs of IR v Anglo Brewing Co Ltd* (1925) 12 TC 803, ex gratia sums paid to employees on closure of a business were held to be non-deductible, because the purpose of the payments was to terminate the employment and wind up the business.
- In *Amalgamated Zinc (de Bavay's) Ltd v FC of T* (1935) 54 CLR 295, the taxpayer contributed to a pension scheme for miners after the company ceased production of zinc concentrate. The payment was held to be non-deductible as the business had ceased.

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