

# TAX INFORMATION

## *Bulletin*

### CONTENTS

- 1 In summary
- 2 Binding rulings  
Product ruling BR Prd 10/01
- 7 New legislation  
Order in Council  
Student loan scheme – volunteer exemption
- 8 Legislation and determinations  
2010 International tax disclosure exemption ITR21
- 13 Legal decisions – case notes  
\$5 million of “loans” found to be income after all  
Allocated salary important when considering “objective test” in tax avoidance cases  
Application to commence challenge proceeding under section 138D of the Tax Administration Act 1994  
Compromise proposals fail to convince Court

## YOUR OPPORTUNITY TO COMMENT

Inland Revenue regularly produces a number of statements and rulings aimed at explaining how taxation law affects taxpayers and their agents. Because we are keen to produce items that accurately and fairly reflect taxation legislation and are useful in practical situations, your input into the process, as a user of that legislation, is highly valued.

A list of the items we are currently inviting submissions on can be found at [www.ird.govt.nz](http://www.ird.govt.nz). On the homepage, click on "Public consultation" in the right-hand navigation. Here you will find drafts we are currently consulting on as well as a list of expired items. You can email your submissions to us at [public.consultation@ird.govt.nz](mailto:public.consultation@ird.govt.nz) or post them to:

Public Consultation  
Office of the Chief Tax Counsel  
Inland Revenue  
PO Box 2198  
Wellington 6140

You can also subscribe to receive regular email updates when we publish new draft items for comment.

Below is a selection of items we are working on as at the time of publication. If you would like a copy of an item please contact us as soon as possible to ensure your views are taken into account. You can get a copy of the draft from [www.ird.govt.nz/public-consultation/](http://www.ird.govt.nz/public-consultation/) or call the Team Manager, Technical Services Unit on 04 890 6143.

Ref	Draft type/title	Description/background information	Comment deadline
ED0117	Draft standard practice statement: Recording Inland Revenue interviews	Draft SPS ED0117 sets out the practice for Inland Revenue when using technology to record interviews.	30 April 2010
XPB0045	Meaning of "anything occurring on liquidation" when a company requests removal from the register of companies	This draft public ruling is a re-issue of public ruling BR Pub 05/14, which expired on 31 December 2008. The expired ruling considered the meaning of "on liquidation" in the context of short form liquidations under the Companies Act, ie when a company requests removal from the register of companies; section 318(1)(d). Only minor changes have been made to the expired ruling. It has been updated for the Income Tax Act 2007 and re-written in parts to make it easier to read.	

# IN SUMMARY

## Binding rulings

### Product ruling BR Prd 10/01

2

This product ruling applies to the raising of capital by Rabo Capital and Rabobank Nederland, by offering to the public New Zealand dollar denominated, perpetual, non-cumulative, non-voting preference shares of up to \$200 million.

## New legislation

### Order in Council

#### Student loan scheme – volunteer exemption

7

Partners Relief and Development NZ has been added to the volunteer exemption list with effect from 1 April 2010.

## Legislation and determinations

### 2010 International tax disclosure exemption ITR21

8

The scope of the 2010 exemption is the same as the 2009 exemption although taxpayers with interests in controlled foreign companies and balance dates between 30 June and 30 September (inclusive), for whom the new international tax rules apply, are required to complete a new prescribed electronic form in relation to CFC disclosure.

## Legal decisions – case notes

### \$5 million of “loans” found to be income after all

13

A property developer who lived largely on “loans” and other drawings from his various companies was held to have thereby avoided income tax.

### Allocated salary important when considering “objective test” in tax avoidance cases

14

The disputant is an anaesthetist who transferred her private practice to a company in which she was a shareholder. A minimum salary was paid by the company for her services. It was held that an arrangement was in place, which when looked at objectively had a purpose of tax avoidance.

### Application to commence challenge proceeding under section 138D of the Tax Administration Act 1994

17

Lack of knowledge by the agents of the taxpayers as to the next step in the dispute process, on the facts of this case, and in the circumstances surrounding the issues constituted exceptional circumstance.

### Compromise proposals fail to convince Court

17

There were a number of significant irregularities in the debtor companies’ compromise proposals. The Court held that it was not appropriate to ratify or grant compromises in these circumstances.

## BINDING RULINGS

This section of the *TIB* contains binding rulings that the Commissioner of Inland Revenue has issued recently.

The Commissioner can issue binding rulings in certain situations. Inland Revenue is bound to follow such a ruling if a taxpayer to whom the ruling applies calculates their tax liability based on it.

For full details of how binding rulings work, see our information booklet *Adjudication & Rulings: A guide to binding rulings (IR 715)* or the article on page 1 of *Tax Information Bulletin*, Vol 6, No 12 (May 1995) or Vol 7, No 2 (August 1995).

You can download these publications free from our website at [www.ird.govt.nz](http://www.ird.govt.nz)

### PRODUCT RULING BR PRD 10/01

This is a product ruling made under section 91E of the Tax Administration Act 1994.

#### Persons to whom the Ruling applies (“the Applicants”)

This Ruling has been applied for by:

- Coöperatieve Centrale Raiffeisen-Boerenleenbank B.A. (“Rabobank Nederland”); and
- Rabo Capital Securities Limited (“Rabo Capital”).

#### Taxation Laws

All legislative references are to the Income Tax Act 2007 (“the Act”) unless otherwise stated.

This Ruling applies in respect of sections CX 56, GB 35 and BG 1.

#### The Arrangement to which this Ruling applies

The Arrangement is the raising of capital by Rabo Capital and Rabobank Nederland. Rabo Capital has offered to the public (in New Zealand and to investors in other jurisdictions where they may be lawfully offered) New Zealand dollar denominated, perpetual, non-cumulative, non-voting preference shares (“PIE Capital Securities”) of up to \$200 million (with the option to accept unlimited oversubscriptions at its discretion). Rabo Capital has accepted applications of \$280 million. The PIE Capital Securities will be listed on the New Zealand Debt Market (“NZDX”).

Rabo Capital will use the funds raised from the issue of the PIE Capital Securities to invest in capital securities issued by Rabobank Nederland (“Underlying Securities”) on or about the issue date of the PIE Capital Securities. Rabobank Nederland will use these funds for its banking business. Some of the funds may be used in its New Zealand business.

The Board of Directors of Rabo Capital and/or the Supervisory Board of Rabobank Nederland have no intention that Rabo Capital and/or Rabobank Nederland

promote the acquisition of PIE Capital Securities by providing holders of PIE Capital Securities or prospective holders with a loan or other financing from any of the companies in the Rabo Capital or Rabobank Nederland Group.

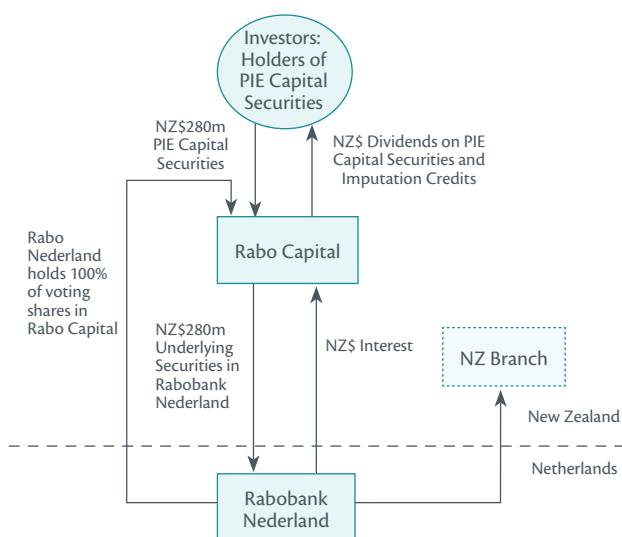
This Ruling does not apply to any holder of PIE Capital Securities who or which has funded the acquisition of PIE Capital Securities by means of borrowing or other financing from any of the companies in the Rabobank group of companies, where such borrowing or other financing was part of an express agreement or arrangement (whether in writing or otherwise) with such company that the proceeds of some or all of such borrowing or other financing would be used for the purposes of acquiring PIE Capital Securities.

Further details of the Arrangement are set out in the paragraphs below.

1. Parties to the Arrangement are:
  - Rabobank Nederland, a cooperative entity incorporated under Dutch law and tax resident in the Netherlands;
  - Rabo Capital, a limited liability company incorporated under New Zealand law which is a wholly-owned subsidiary of Rabobank Nederland; and
  - holders of PIE Capital Securities.
2. The transactions comprising the Arrangement are governed by documents that were provided to Inland Revenue on 2 April, 22 April or 24 April 2009. The documents are:
  - Agency Agreement between Rabo Capital, Rabobank Nederland and Computershare Investor Services Limited (“Registrar”) dated 16 April 2009 (“Agency Agreement”);
  - Terms and Conditions of the Underlying Securities set out in Exhibit A of the Agency Agreement;

- Constitution of Rabo Capital registered with the New Zealand Companies Office on 27 April 2009 (“the Constitution”);
- Terms and Conditions of the PIE Capital Securities attached as the Appendix to the Constitution (“PIE Conditions”);
- Investment Statement for the purposes of the Securities Act 1987 for the offer of PIE Capital Securities, dated 17 April 2009 (“the Investment Statement”);
- NZX Regulation Decision dated 17 April 2009; and
- Listing Agreement NZDX Market between Rabo Capital and NZX Limited (“NZX”).

3. The Arrangement is summarised in the diagram below:



4. The PIE Capital Securities and the Underlying Securities will constitute Tier 1 Capital of the Rabobank Group (comprising Rabobank Nederland together with its branches, consolidated subsidiaries and local member banks, including Rabo Capital) for the purposes of the Dutch Central Bank, which is the home prudential authority for Rabobank Nederland.

## Rabo Capital

### Incorporation of Rabo Capital

5. Rabo Capital is a special purpose company incorporated on 15 April 2009 under the Companies Act 1993 with 1000 \$1 ordinary shares, all of which are held by Rabobank Nederland. Rabobank Nederland is a cooperative entity incorporated under Dutch law and tax resident in the Netherlands.
6. The ordinary shares carry all the voting rights in Rabo Capital but the holder of the ordinary shares is not, by virtue of that holding, entitled to participate in any dividend or distribution (including by way of a return of capital) made by Rabo Capital.

### Rabo Capital Constitution

7. Rabo Capital has no power to carry on any business or activity other than that described in the Constitution.
8. Clause 5.1 of the Constitution states:

**5.1 Limitation on Business:** The only business or activity which the Company may carry on is to:

- (a) issue and maintain in existence PIE Capital Securities, including listing (and maintaining a listing of) those shares on any stock or securities exchange in New Zealand or elsewhere;
- (b) use the proceeds of PIE Capital Securities to subscribe for perpetual Tier 1 bonds issued by Rabobank Nederland, or a related company of Rabobank Nederland;
- (c) enter into the Agency Agreement and the Security Trust Deed (and any other administration agreements, security trust deeds, registration agreements and/or deed polls in connection with the issue of PIE Capital Securities); and
- (d) do all other things reasonably incidental to the activities referred to in sub-paragraphs (a), (b), (c) above and this Constitution.

The Company has no power to:

- (e) carry on any other business or activity; or
- (f) apply amounts received by way of interest on, or repayment of, the bonds referred to in sub-paragraph (b) above for any purpose other than in payments to Holders, meeting costs and expenses incurred in connection with the issuance and maintenance in existence of PIE Capital Securities and making income and other tax payments to the New Zealand Inland Revenue Department.

9. Rabo Capital elected to be a “portfolio listed company” (“PLC”) under the “portfolio investment entity” (“PIE”) regime on 22 April 2009, with a commencement date of 27 May 2009.

10. Under the Constitution, Rabo Capital may take all steps it considers necessary or desirable to ensure it continues to be eligible as a PIE and a PLC or otherwise to comply with the requirements of the Act relating to PIEs. These requirements include (but are not limited to):

- refusing to register the transfer of any PIE Capital Securities;
- treating the transfer of any PIE Capital Securities as void (ab initio or from such other date as Rabo Capital may decide in its complete discretion) (clause 3(i)(ii) of the PIE Conditions);
- deeming any PIE Capital Securities held that would result in any holder (or where the holder is a nominee their beneficial owner) exceeding the maximum holding that an investor may hold in Rabo Capital in order for it to meet the PIE eligibility

requirements in the Act, to be held by the holder of the PIE Capital Securities on trust for any member of the Rabobank Group appointed by Rabo Capital and allowing such member full powers of direction in relation to those PIE Capital Securities, including when, how and to whom they may be transferred (clause 3(i)(ii) of the PIE Conditions);

- allowing Rabo Capital or the Registrar to request any holder (or any person associated with that holder) of PIE Capital Securities to provide such information or evidence as it may require to determine whether Rabo Capital is eligible or continues to be eligible as a PIE and qualify as a PLC and, where holders do not provide such information within specified time periods, deeming that such holder's (or where the holder is a nominee, such beneficial owner's) PIE Capital Securities are held on trust for a member of the Rabobank Group appointed by Rabo Capital and such member of the Rabobank Group shall have full powers of direction in relation to those PIE Capital Securities including when, how and to whom they may be transferred (clauses 3(i)(iii) and (iv) of the PIE Conditions);
- allowing Rabo Capital or the Registrar to take any of the steps in clause 3(i)(v) of the PIE Conditions to ensure that any breach of the PIE regime "investor interest size" requirement is remedied within the period required by the Act.

### PIE Capital Securities

11. Rabo Capital offered PIE Capital Securities with a face value of \$1 each to the public in New Zealand for \$1 per security. The minimum holding amount is \$5,000. The offer, which opened on 27 April 2009 and closed on 22 May 2009, was available to retail and institutional investors. Rabobank Nederland acquired 5,000 PIE Capital Securities on 5 February 2010.
12. On 25 May 2009 Rabo Capital accepted a total of \$280 million in applications.
13. Rabo Capital has entered into a Listing Agreement with NZX for the PIE Capital Securities to be quoted on the NZDX (the debt security market operated by NZX). Although the PIE Capital Securities are not debt securities for the purposes of the Securities Act 1978, NZX Regulation has given certain rulings and waivers from the NZDX Listing Rules in relation to the listing of the PIE Capital Securities on the NZDX.
14. The PIE Capital Securities are perpetual non-cumulative non-voting preference shares of Rabo Capital and shall at all time rank *pari passu* and without any preference among themselves (clause 4(a) of the PIE Conditions).

They are direct, unsecured and subordinated obligations of Rabo Capital and are not guaranteed by Rabobank Nederland or any other person.

15. Dividends will be paid on the PIE Capital Securities quarterly in arrears on the "Initial Rate Dividend Payment Date", with the first dividend payment date scheduled to occur on 18 June 2009 (clause 5(c) of the PIE Conditions).
16. The dividend amount is the amount of cash payable to holders of PIE Capital Securities on the relevant dividend payment date. The dividend amount for each dividend period from 18 June 2009 to 18 June 2019 is calculated as follows:

$$\frac{\text{face value} \times \text{dividend rate} \times (1 - t)}{4}$$

Where "t" is the weighted basic rate of New Zealand corporate income tax expressed as a percentage applicable to Rabo Capital (currently 30 percent) during the period ending on the relevant dividend payment date.

The "dividend rate" used to calculate the dividend amount will be as follows:

- (a) for the first 10 years, the initial rate, which is equal to the sum of the margin and the benchmark rate (the five-year swap rate), which will be reset after five years; and
- (b) thereafter, the floating rate, which is equal to the sum of the margin and the three-month bank bill rate, which is reset quarterly.

17. The Investment Statement contains the following statement, relating to dividends payable on the PIE Capital Securities (at page 6):

**Dividend:**

The PIE Capital Securities will pay a non-cumulative dividend. Dividend Amounts are scheduled to be paid quarterly on each 18 March, 18 June, 18 September and 18 December. The Dividend Amount is the cash component of the dividend and is a proportion of the amount calculated using the Dividend Rate. Dividend Amounts payable on the PIE Capital Securities will be paid to the person registered as the Holder on the relevant Record Date (including in relation to the first Dividend Amount payable).

**Initial Dividend Rate:**

The initial Dividend Rate will be set for an initial period of approximately 5 years from the Issue Date to 18 June 2014 at the greater of:

- the Minimum Initial Rate, which is 8% per annum; and
- the Benchmark Rate on 25 May 2009 plus the Margin.

**Dividend Rate reset:**

The Dividend Rate will be reset for a further 5 years on 18 June 2014 at the prevailing Benchmark Rate plus the Margin. From 18 June 2019 the Dividend Rate will reset quarterly, at the 90 day bank bill rate plus the Margin.

18. On 25 May 2009 the dividend rate for the period until 18 June 2014, incorporating the margin (which has been set at 3.75 percent per annum) and the swap rate, was set at 8.7864 percent per annum.
19. Rabo Capital will attach imputation credits to distributions made to holders of PIE Capital Securities to the maximum extent permitted by the imputation credits available. The Investment Statement contains the following statement (at page 11):

**Imputation Credits**

The Issuer will attach imputation credits to Dividend Amounts to the extent permitted by the imputation credits that the directors of the Issuer determine are available. It is expected that dividends will have imputation credits fully attached to a Dividend Amount (30/70th of the Dividend Amount assuming a corporate tax rate of 30%). If the Issuer does not fully impute a Dividend Amount, this may trigger an Exchange Event and the PIE Capital Securities may, at the Issuer's option, exchange into the Underlying Securities issued by Rabobank Nederland or be redeemed. Alternatively, the Issuer may, at its discretion, put in place an arrangement to reimburse Holders who are adversely affected by the dividends not being fully imputed.

**Underlying Securities**

20. Rabo Capital will use the funds raised from the issue of PIE Capital Securities to invest in Underlying Securities issued by Rabobank Nederland on or about the issue date of the PIE Capital Securities. The Underlying Securities are interest-bearing, unsecured, perpetual, non-cumulative subordinated bonds. The principal amount of the Underlying Securities will be equal to the subscription amount of the PIE Capital Securities. The Underlying Securities will have terms conforming substantially to the terms of the PIE Capital Securities. However, the Underlying Securities will be bonds paying interest rather than shares paying imputed dividends. The Underlying Securities will be the only material asset of Rabo Capital and at least 90 percent of the income Rabo Capital will derive will be interest from its investment in the Underlying Securities.
21. Rabobank Nederland will use the funds raised from the issue of Underlying Securities for its banking business. The funds are not being raised specifically for the purposes of Rabobank Nederland's New Zealand branch ("NZ Branch"), although Rabobank Nederland may "on-lend" some of the funds raised to NZ Branch.

22. Interest received by Rabo Capital on the Underlying Securities will constitute assessable income for Rabo Capital.

**Termination of Arrangement**

23. The PIE Capital Securities are perpetual securities that have no scheduled repayment date, but the PIE Capital Securities will be redeemed in the following circumstances (among others). The circumstances are set out in clause 8 of the PIE Conditions and are:
- if Rabo Capital exercises the option contained in clause 8(c) of the PIE Conditions and elects to redeem the PIE Capital Securities on the "First Call Date" which is specified as being 18 June 2019 or on any dividend payment date thereafter;
  - if, as a result of a Netherlands tax law change, there is more than an insubstantial risk that additional amounts are payable under the Underlying Securities or interest payable on the Underlying Securities would not be deductible to Rabobank Nederland for Netherlands tax purposes and Rabo Capital elects to redeem the PIE Capital Securities;
  - if the Dutch Central Bank notifies Rabo Capital that the PIE Capital Securities may not be included in consolidated Tier 1 Capital of the Rabobank Group and Rabo Capital elects to redeem the PIE Capital Securities;
  - where the Underlying Securities are redeemed; or
  - on the occurrence of certain "Exchange Events" the PIE Capital Securities may be, at the option of Rabo Capital either cancelled and exchanged for Underlying Securities with a face value equal to the face value of the PIE Capital Securities or redeemed. The types of circumstances that would constitute an "Exchange Event" are described in the "Definitions" section of the PIE Conditions and summarised in the Investment Statement as follows (at page 12):

**Exchange Events**

On the occurrence of certain events (each an "Exchange Event") the PIE Capital Securities may, at the option of the Issuer, exchange into the Underlying Securities issued by Rabobank Nederland or be redeemed. The Exchange Events are:

- if the Dutch Central Bank requires that all PIE Capital Securities must be issued directly by Rabobank Nederland; or
- an Insolvency Event in relation to the Issuer or Rabobank Nederland; or
- a default by the Issuer for more than 30 days in the payment of Dividend Amounts or Redemption Amounts (other than relating to an administrative error) in respect of any of the PIE Capital Securities; or

- (d) any of the following events that the Issuer determines in its absolute discretion is an Exchange Event;
- (i) an Increased Costs Event; or
  - (ii) any Tax Law Change which has or is expected to have the effect that the anticipated tax outcomes for the Issuer or for Holders as at the Issue Date are adversely affected (as determined by the Issuer); or
  - (iii) the Issuer does not impute a Dividend Amount at the maximum imputation ratio under the Tax Act and an arrangement is not in place, or in the Issuer's opinion is not expected to be in place, within 90 Business Days of the relevant Dividend Payment Date to fully reimburse Holders who are adversely affected; or
  - (iv) the New Zealand Inland Revenue Department has indicated that it will not provide or renew a satisfactory binding ruling or rulings (as determined by the Issuer) confirming the anticipated tax implications of the transaction for the Issuer and the Holders.

Upon the occurrence of an Exchange Event, Holders of the PIE Capital Securities may, at the option of the Issuer, receive Underlying Securities in a principal amount equal to the Redemption Amount of each Holder's PIE Capital Securities at the relevant time or have their PIE Capital Securities redeemed. Prior to the distribution to Holders of the Underlying Securities or redemption, any Outstanding Amounts and any surplus amounts (after accounting for the Outstanding Amounts and the distribution of the Underlying Securities) held by the Issuer will be paid out pro rata to Holders.

#### Administration costs

24. It is expected that Rabo Capital will pay for ongoing costs and expenses related to the issue of PIE Capital Securities. If Rabo Capital has insufficient funds with which to pay these costs and expenses, Rabobank Nederland will reimburse Rabo Capital for the costs and expenses. Because of this arrangement, it is unlikely Rabo Capital will pay an administration fee to Rabobank Nederland, but in the event that any administration fee is paid in the future, such administration fee will not exceed an arm's length amount.
25. The New Zealand branch of Rabobank Nederland ("NZ Branch") will provide a liquidity facility to Rabo Capital pursuant to which Rabo Capital may request advances of up to NZ\$10 million from NZ Branch. Any interest paid by Rabo Capital to NZ Branch pursuant to the liquidity facility will be on arm's length terms or, if not on arm's length terms, on terms that are in

favour of Rabo Capital. It is expected that money from this funding facility will only be used to pay tax or other expenses of Rabo Capital if it has insufficient available funds before receiving income under the Underlying Securities. There is no intention on the part of the Board of Directors of Rabo Capital and/or the Supervisory Board of Rabobank Nederland that Rabo Capital, Rabobank Nederland and/or NZ Branch would be paid any of the income that should otherwise be paid to the holders of PIE Capital Securities.

#### Condition stipulated by the Commissioner

This Ruling is made subject to the following condition:

- a) This Product Ruling will cease to apply if the Binding Private Ruling (BR Prv 10/05) issued in respect of the Rabo Capital PIE regime Arrangement no longer applies or Rabo Capital ceases to be eligible to be a PIE and a PLC.

#### How the Taxation Laws apply to the Applicants and the Arrangement

Subject in all respects to any condition stated above, the Taxation Laws apply to the Applicants and the Arrangement as follows:

- Distributions or dividends made by Rabo Capital to holders of PIE Capital Securities will constitute excluded income of a New Zealand tax resident holder who is a natural person or a trustee and who does not include the amount as income in their return of income for the income year, pursuant to section CX 56(3)(a).
- Where section CX 56(3)(a) does not apply, distributions or dividends made by Rabo Capital to holders of the PIE Capital Securities will be excluded income of a holder to the extent to which the amount of the distribution is more than the amount of the distribution that is fully imputed (as described in section RF 9(2)) pursuant to section CX 56(3)(b)(i).
- Section GB 35 does not apply to the Arrangement.
- Section BG 1 does not apply to vary or negate the above conclusions.

#### The period or income year for which this Ruling applies

This Ruling will apply for the period beginning on 27 May 2009 and ending on 30 June 2014.

This Ruling is signed by me on the 12th day of March 2010.

**Howard Davis**  
Director (Taxpayer Rulings)



## NEW LEGISLATION

### ORDER IN COUNCIL

---

#### **STUDENT LOAN SCHEME – VOLUNTEER EXEMPTION**

Partners Relief and Development NZ has been added to the list of organisations that are “named” for the purposes of section 38AE(1)(b) of the Student Loan Scheme Act 1992, with effect from 1 April 2010.

The effect of being “named” is that student loan borrowers working overseas as volunteers or for a token payment for these organisations may be granted an exemption, for a period of up to two years, from the requirement that they be present in New Zealand for 183 or more days to qualify for an interest-free loan.

Borrowers must be engaged in one or more of the following activities to qualify for the exemption:

- work to relieve poverty, hunger, sickness, or the ravages of war or natural disaster;
- work to improve the economy of a developing country; or
- work to raise the educational standards of a developing country.

Student loan borrowers seeking the exemption should contact their local Inland Revenue office.

*Student Loan Scheme (Charitable Organisations)  
Amendment Regulations 2010 (SR 2010/28)*

## LEGISLATION AND DETERMINATIONS

This section of the *TIB* covers items such as recent tax legislation and depreciation determinations, livestock values and changes in FBT and GST interest rates.

### 2010 INTERNATIONAL TAX DISCLOSURE EXEMPTION ITR21

#### Introduction

Section 61 of the Tax Administration Act 1994 (“TAA”) requires taxpayers to disclose interests in foreign entities.

Section 61(1) of the TAA states that a person who has a control or income interest in a foreign company or an attributing interest in a foreign investment fund (FIF) at any time during the income year must disclose the interest held.<sup>1</sup> However, section 61(2) of the TAA allows the Commissioner of Inland Revenue to exempt any person or class of persons from this requirement if disclosure is not necessary for the administration of the international tax rules (as defined in section YA 1) contained in the Income Tax Act 2007 (“the ITA 2007”).

To balance the revenue forecasting and risk assessment needs of the Commissioner with the compliance costs of taxpayers providing the information, the Commissioner has issued an international tax disclosure exemption under section 61(2) of the TAA that applies for the income year corresponding to the tax year ended 31 March 2010. This exemption may be cited as “International Tax Disclosure Exemption ITR21” and the full text appears at the end of this item.

#### Scope of exemption

The scope of the 2010 exemption is the same as the 2009 exemption although taxpayers with interests in controlled foreign companies (CFCs) and balance dates between 30 June and 30 September (inclusive), for whom the new international tax rules apply, are required to complete a new prescribed electronic form in relation to CFC disclosure. These changes are outlined further below.

#### Application date

This exemption applies for the income year corresponding to the tax year ending 31 March 2010.

#### Summary

In summary, the 2010 international tax disclosure exemption removes the requirement of a resident to disclose:

- an interest of less than 10% in a foreign company that is not an attributing interest in a FIF, or is an attributing interest

in a FIF in respect of which no FIF income or loss arises under either section CQ 5(1)(d) or section DN 6(1)(d) of the Income Tax Act 2007

- if the resident is **not** a widely-held entity, an attributing interest in a FIF that is an income interest of less than 10%, if the foreign entity is incorporated (in the case of a company) or otherwise tax resident in a treaty country, and the fair dividend rate or comparative value method of calculation is used
- if the resident is a widely-held entity, an attributing interest in a FIF that is an income interest of less than 10% and the fair dividend rate or comparative value method is used. The resident is instead required to disclose the end-of-year New Zealand dollar market value of such investments split by the jurisdiction in which the attributing interest in a FIF is held or listed.

The 2010 disclosure exemption also removes the requirement for a non-resident or transitional resident to disclose interests held in foreign companies and FIFs.

#### Explanation

Generally, residents who hold an income interest or a control interest in a foreign company, or an attributing interest in a FIF are required to disclose these interests to the Commissioner. These interests are considered in further detail below.

#### *Attributing interest in a FIF*

A resident is required to disclose an attributing interest in a FIF where FIF income or FIF loss arises through the use of one of the following calculation methods:

- branch equivalent, accounting profits, deemed rate of return or cost methods; or
- fair dividend rate or comparative value methods where the resident is a “widely-held entity”; or
- fair dividend rate or comparative value methods, the resident is not a widely-held entity and the country in which the attributing interest is incorporated or otherwise tax resident in a country that New Zealand **does not** have a double tax agreement in force as at 31 March 2010.

<sup>1</sup> In the case of partnerships, disclosure needs to be made by the individual partners in the partnership. The partnership itself is not required to disclose.

The 35 countries that New Zealand does have a double tax agreement in force as at 31 March 2010 are listed below.

Australia	India	Russian Federation
Austria	Indonesia	Singapore
Belgium	Ireland	South Africa
Canada	Italy	Spain
Chile	Japan	Sweden
China	Korea	Switzerland
Czech Republic	Malaysia	Taiwan
Denmark	Mexico	Thailand
Fiji	Netherlands	United Arab Emirates
Finland	Norway	United Kingdom
France	Philippines	United States of America
Germany	Poland	

No disclosure is required by non-widely-held taxpayers for attributing interests in FIFs that are incorporated or otherwise tax resident in a tax treaty country, if the fair dividend rate or comparative value methods of calculation are used.

A “widely-held entity” for the purposes of this disclosure is an entity which is a:

- portfolio investment entity (this includes a portfolio investment-linked life fund); or
- widely-held company; or
- widely-held superannuation fund, or
- widely-held group investment fund (“GIF”).

Portfolio investment entity, widely-held company, widely-held superannuation fund and widely-held GIF are all defined in section YA 1 of the ITA 2007.

The disclosure required by widely-held entities of attributing interests in FIFs which use the fair dividend rate or the comparative value method of calculation is that, for each calculation method, they disclose the end-of-year New Zealand dollar market value of investments split by the jurisdiction in which the attributing interest in a FIF is held or listed. A split by currency in which the investment is held, will also be accepted as long as it is a reasonable proxy—that is at least 90–95% accurate—for the underlying jurisdictions. For example, investments denominated in euros will not be able to meet this test and so euro-based investments will need to be split into the underlying jurisdictions.

#### FIF interests

The types of interests that fall within the scope of section 61(1) of the TAA are:

- rights in a foreign company or anything deemed to be a company for the purposes of the ITA (eg, a unit trust)
- an entitlement to benefit from a foreign superannuation scheme

- an entitlement to benefit from a foreign life insurance policy
- an interest in an entity specified in schedule 25, part A of the ITA (no entities were listed when this issue of the *Tax Information Bulletin* went to press).

However, the following interests are exempt (under sections EX 31 to EX 43 of the ITA) from being an attributing interest in a FIF and do not have to be disclosed:

- an income interest of 10% or more in a CFC (although separate disclosure is required of this as an interest in a foreign company)
- certain interests in Australian resident companies listed on an approved index of the Australian Stock Exchange and required to maintain a franking account (refer to the IR 871 form that can be found on Inland Revenue’s website [www.ird.govt.nz](http://www.ird.govt.nz) (keywords: other exemptions))
- an interest in an Australian unit trust that has an RWT proxy with either a high turnover or high distributions
- an interest of 10% or more in a foreign company that is treated as resident in a country or territory specified in the grey list
- an interest in certain grey-list companies (only interests in Guinness Peat Group plc qualify for this exemption)
- an interest in an employment-related foreign superannuation scheme
- certain foreign pensions or annuities (see Inland Revenue’s booklet *Overseas private pensions (IR 257)* for more information)
- an interest in certain venture capital investments in New Zealand resident start-up companies that migrate to a grey-list country
- an interest in certain grey-list companies owning New Zealand venture capital companies
- an interest in certain grey-list companies resulting from shares acquired under a venture investment agreement
- an interest in certain grey-list companies resulting from the acquisition of shares under an employee share scheme
- an interest held by a natural person in a foreign entity located in a country where exchange controls prevent the person deriving any profit or gain or disposing of the interest for New Zealand currency or consideration readily convertible to New Zealand currency.

Interests in foreign entities held by a natural person not acting as a trustee also do not have to be disclosed if the total cost of the interests remains under \$50,000 at all times during the income year. This disclosure exemption is made because no FIF income under section CQ 5 of the ITA or FIF loss under section DN 6 arises in respect of these interests.

### *Format of disclosure*

The forms for the disclosure of FIF interests are as follows:

- IR 439 form for the accounting profits method
- IR 440 form for the branch equivalent method
- IR 443 form for the deemed rate of return method
- IR 445 form for the fair dividend rate method (for widely-held entities)
- IR 446 form for the comparative value method (for widely-held entities)
- IR 447 form for the fair dividend rate method (for individuals or non-widely-held entities)
- IR 448 form for the comparative value method (for individuals or non-widely-held entities)
- IR 449 form for the cost method.

The IR 445 and IR 446 forms must be completed online. The IR 447, IR 448 and IR 449 forms may be completed online. The online forms can be found at [www.ird.govt.nz](http://www.ird.govt.nz) "Get it done online", "Foreign investment fund disclosure".

As a transitional measure for non-portfolio FIFs using the branch equivalent or accounting profits methods, an alternative to using the IR 439 and IR 440 forms is acceptable for the income year corresponding to the tax year ending 31 March 2010. For each calculation method, an acceptable alternative disclosure will be a schedule outlining all the FIF interests of a particular taxpayer and must, as a minimum, include the following information:

- details of the taxpayer filing the form, including name, IRD number, contact details
- details of the FIF, including name, business activity, balance date, country of residence, address
- nature of the taxpayer's FIF interest (ie, shares or units)
- details of the taxpayer's income interest percentage (including details of the measurement basis used)
- currency the financial statements were prepared in
- calculation of FIF income or loss including conversion rate and NZD conversion calculation
- details of any loss offset or loss to carry forward
- details of any foreign tax credit available (including details of NZD conversion calculation).

A scanned copy of the audited financial statements of the FIF must also accompany the schedule(s).

The alternative disclosure schedules and audited financial accounts should be sent to the following email address: [439440disclosure@ird.govt.nz](mailto:439440disclosure@ird.govt.nz)

The alternative disclosure schedule filed must also be printed, dated and signed by the taxpayer as true and correct. This should be held on file by the taxpayer and may be requested by the Commissioner.

### *Income interest of 10% or more in a foreign company*

A resident is required to disclose an income interest of 10% or more in a foreign company. This obligation to disclose applies to all foreign companies regardless of the country of residence. For this purpose, the following interests need to be considered:

- a) an income interest held directly in a foreign company
- b) an income interest held indirectly through any interposed foreign company
- c) an income interest held by an associated person (not being a controlled foreign company) as defined by the parts of subpart YB of the ITA that apply for the purposes of the "1988 version provisions".

To determine whether a resident has an income interest of 10% or more for CFCs, sections EX 14 to EX 17 of the ITA should be applied. To determine whether a resident has an income interest of 10% or more in any entity that is not a CFC, for the purposes of this exemption, sections EX 14 to EX 17 should be applied to the foreign company as if it were a CFC.

### *Format of disclosure*

New international tax rules have been introduced for calculating income from a CFC. These rules apply for all income years beginning on or after 1 July 2009. Entities with late balance dates between 30 June 2010 and 30 September 2010 (inclusive) will begin their 2010 income year on or after 1 July 2009. Therefore, entities with balance dates between 30 June and 30 September (inclusive) will apply the new rules from their 2010 income year.

Disclosure of interests in a controlled foreign company, by an entity applying the new rules, is required using a *Controlled foreign companies disclosure (IR 458)* form.

The IR 458 form must be completed online at [www.ird.govt.nz](http://www.ird.govt.nz) (keyword: ir458).

Disclosure of interests in a controlled foreign company, by an entity applying the old rules, and interests in a foreign company that is not a controlled foreign company, is required using either an IR 477 or IR 479 form (*Interest in a foreign company disclosure schedule*) as appropriate.

### *Overlap of interests*

It is possible that a resident may be required to disclose an interest in a foreign company which also constitutes an attributing interest in a FIF. For example, a person with an income interest of 10% or greater in a foreign company

which is not a CFC is strictly required to disclose both an interest held in a foreign company and an attributing interest in a FIF.

To meet disclosure requirements, only one form of disclosure is required for each interest. If the interest is an attributing interest in a FIF, then the appropriate disclosure for the calculation method, as discussed previously, must be made.

In all other cases, the IR 477 or IR 479 must be used if the new international tax rules do not yet apply, and the IR 458 if they do.

### *Interests held by non-residents and transitional residents*

Interests held by non-residents and transitional residents in foreign companies and FIFs do not need to be disclosed.

This would apply for example to an overseas company operating in New Zealand (through a branch) in respect of its interests in foreign companies and FIFs; or to a transitional resident with interests in a foreign company or an attributing interest in a FIF.

Under the international tax rules, non-residents and transitional residents are not required to calculate or attribute income under either the CFC or FIF rules. Therefore disclosure of non-residents' or transitional residents' holdings in foreign companies or FIFs is not necessary for the administration of the international tax rules and so an exemption is made for this group.

## **PERSONS NOT REQUIRED TO COMPLY WITH SECTION 61 OF THE TAX ADMINISTRATION ACT 1994**

This exemption may be cited as "International Tax Disclosure Exemption ITR21".

### **1. Reference**

This exemption is made under section 61(2) of the Tax Administration Act 1994. It details interests in foreign companies and attributing interests in FIFs in relation to which any person is not required to comply with the requirements in section 61 of the Tax Administration Act 1994 to make disclosure of their interests, for the income year ending 31 March 2010.

### **2. Interpretation**

For the purpose of this disclosure exemption to determine an income interest of 10% or more, sections EX 14 to EX 17 of the Income Tax Act 2007 apply for interests in controlled foreign companies. In the case of attributing interests in FIFs, those sections are to be applied as if the FIF were a CFC.

The relevant definition of "associated persons" is contained in the parts of subpart YB of the Income Tax Act 2007 that apply for the purposes of the "1988 version provisions".

Otherwise, unless the context requires, expressions used have the same meaning as in section YA 1 of the Income Tax Act 2007.

### **3. Exemption**

- i) Any person who holds an income interest of less than 10% in a foreign company, including interests held by associated persons, that is not an attributing interest in a FIF, or that is an attributing interest in a FIF in respect of which no FIF income or loss arises under either section CQ 5(1)(d) or section DN 6(1)(d) of the Income Tax Act 2007, is not required to comply with section 61(1) of the Tax Administration Act 1994 for that interest and that income year.
- ii) Any person who is a portfolio investment entity, widely-held company, widely-held superannuation fund or widely-held GIF, who has an attributing interest in a FIF, other than a direct interest of 10% or more in a foreign company that is not a foreign investment vehicle, and uses the fair dividend rate or comparative value calculation method for that interest, is not required to comply with section 61(1) of the Tax Administration Act 1994 in respect of that interest and that income year, if the person discloses the end-of-year New Zealand dollar market value of investments, in an electronic format prescribed by the Commissioner, split by the jurisdiction in which the attributing interest in a FIF is held or listed.
- iii) Any person who is not a portfolio investment entity, widely-held company, widely-held superannuation fund or widely-held GIF, who has an attributing interest in a FIF, other than a direct income interest of 10% or more, and uses the fair dividend rate or comparative value calculation method is not required to comply with section 61(1) of the Tax Administration Act 1994 in respect of that interest and that income year, to the extent that the FIF is incorporated or tax resident in a country with which New Zealand has a double tax agreement in force at 31 March 2010.
- iv) Any non-resident person or transitional resident who has an income interest or a control interest in a foreign company or an attributing interest in a FIF in the income year corresponding to the tax year ending 31 March 2010, is not required to comply with section 61(1) of the Tax Administration Act 1994 in respect of that interest and that income year if either or both of the following apply:

- no attributed CFC income or loss arises in respect of that interest in that foreign company under sections CQ 2(1)(d) or DN 2(1)(d) of the Income Tax Act 2007; and/or
- no FIF income or loss arises in respect of that interest in that FIF under sections CQ 5(1)(f) or DN 6(1)(f) of the Income Tax Act 2007.

This exemption is made by me acting under delegated authority from the Commissioner of Inland Revenue pursuant to section 7 of the Tax Administration Act 1994.

This exemption is signed on the 9th of March 2010.

**Tony Morris**

Assurance Manager (Large Enterprises)

## LEGAL DECISIONS – CASE NOTES

This section of the TIB sets out brief notes of recent tax decisions made by the Taxation Review Authority, the High Court, Court of Appeal, Privy Council and the Supreme Court.

We've given full references to each case, including the citation details where it has already been reported. Details of the relevant Act and section will help you to quickly identify the legislation at issue. Short case summaries and keywords deliver the bare essentials for busy readers. The notes also outline the principal facts and grounds for the decision.

These case reviews do not set out Inland Revenue policy, nor do they represent our attitude to the decision. These are purely brief factual reviews of decisions for the general interest of our readers.

### \$5 MILLION OF “LOANS” FOUND TO BE INCOME AFTER ALL

<b>Case</b>	TRA Decision 3/2010
<b>Decision date</b>	27 January 2010
<b>Act</b>	Income Tax Act 1994
<b>Keywords</b>	Avoidance, loans, capital, journal entry, structure

#### Summary

A property developer who lived largely on “loans” and other drawings from his various companies was held to have thereby avoided income tax.

#### Impact of decision

Tax avoidance jurisprudence has moved very quickly in New Zealand since the Supreme Court decisions in *Glenharrow* and *Ben Nevis*. In this case the Authority has applied the relatively new test of “parliamentary contemplation” as well as the more conventional BG1 analyses to a somewhat extreme fact pattern. The Commissioner considers the decision to largely turn on its own facts.

#### Facts

The disputant is a property developer and entrepreneur. During the period 1991 to 2002 he was involved in projects worth, at least, hundreds of millions of dollars. Over that period he paid less than \$20,000 net income tax. The disputant did, however, avail himself of loans from entities he controlled. These “loans” amounted to \$5,094,442 over the 12-year period. The Commissioner considered the loans and the mechanisms by which the disputant and his entities accounted for profits or gains, to be a tax avoidance arrangement. The disputant was assessed in his personal capacity for income equivalent to the unrepaid loans over the 12-year period.

His Honour Judge Barber described the disputant's business method:

[11] I understood that these projects, involving developing land on revenue account, were effected in separate trusts and, at the end of each project, the profit was distributed to the next trust development project, which would be in start-up at that stage and so on and so on. Some projects seem to be the erection (or renovation) of buildings on land for resale but, very often, for retention by the disputant's group as a letting enterprise.

[12] Simply put, in order for the disputant and his family to live in the manner he wished, there were constant and very regular drawings by the disputant from his entities. Generally, no salary was paid to him, and the drawings were treated by his accountants, and for the purposes of his tax position, as loans of capital. Mr Lennard's strong submission is that capital was the character of the advances by these group entities to the disputant over the said 12 years.

[13] As I understand it, the said technique applied by the accountants and advisers for the disputant, leading to him not appearing to receive earnings, continued unnoticed by the IRD for many years until one of the development projects led to significant losses for the particular group entity ... In examining the fallout from that failure, the regular and systematic drawings taken for living by the disputant, and set out in the relevant book-keeping as loans, showed up, possibly, because creditors saw them as an asset of the lender trust entity to be repaid by the disputant.

[14] The disputant's group operated in a tax efficient manner. Virtually no income tax was paid. It is submitted for the defendant that the arrangement was a device whereby the disputant could live off funds obtained from his entities without paying any tax and that there is no other objective rationale for the arrangement.

Some “repayments” were made by book entry into various loan accounts whenever the Group realised a capital gain:

[56] ... Most repayments were by journal entry. If any trust obtained a capital benefit, this could be distributed to the disputant by journal entry and immediately utilised by him again, by journal entry, in repayment of a loan. In economic terms it means that when an entity obtains a capital amount, the loan can be reduced by that amount with his entities still having the funds available for other projects. That after the repayment the funds may be in a different disputant entity is not significant. The disputant confirmed under cross-examination that there was no difficulty in moving funds within the group and that it is done “all the time”.

## Decision

The Authority embarked upon a comprehensive BG1 analysis in order to determine whether the purported loaned capital receipts were in fact income in the hands of the disputant.

His Honour held that there was a tax avoidance arrangement which consisted of:

- [a] the disputant borrowing funds from the trust, the said company and other associated entities/trusts;
- [b] a fundamental component of the arrangement was the terms on which such amounts were loaned to the disputant, including no defined date for repayment;
- [c] no (or only slight, depending on the income year) taxable distributions or amounts being paid by the associated entities/trusts to the disputant; the repayments of the loans that were made were sourced from non-taxable distributions received from his associated entities.

The arrangement was held to have avoided tax by virtue of the control the disputant had over all his trading entities:

[35] In theory, the disputant must repay the loans but, since he controls the associated entities, he can control when and to what extent demand for payment is made. The repayment can be indefinitely deferred. He could control whether interest was charged; and it did not seem to be. The repayments were merely circular flows of funds that have no economic effect on the disputant’s entities other than that the loan balance is reduced or cancelled. The money for the repayment was provided by the disputant’s entities and with the repayment being returned to those entities, although not necessarily the same entity.

Judge Barber agreed with the Commissioner’s submission that there could be no commercial rationale for such structuring and arrangement and that it could only be explained in terms of tax benefits. For example, when the Group needed funding for another project, it would take on high-interest commercial finance rather than call in the interest-free loan made to the disputant. At [61]:

The arrangement is explicable in terms of tax. The arrangement has enabled the disputant to avoid falling within the specific provisions relating to assessability of payment/reward for services, in particular sections CD 5 and CH 3 of the Income Tax Act 1994. The arrangement has also avoided the provisions which assess beneficiary income or, where a company, dividends. Even if I could find that the arrangement had a commercial purpose, the tax benefit is sufficiently significant for it to be a purpose other than a merely incidental purpose.

Regarding the time bar, it was submitted for the disputant that section 108 requires that there be an omission of “income ... of a particular nature ... or derived from a particular source”. The disputant claimed that as the Commissioner had reconstructed the loans as income, and

that the disputant had returned certain items of income in his tax returns, then the particular nature/source test was satisfied. His Honour held otherwise:

[105] The section is directed at the failure to mention income, not a failure to characterise it as income. In *Cross v CIR* [1987] 9 NZTC 6,101, at 6,111, Somers J considered that the exception does not require a taxpayer to return an amount as income if the taxpayer asserts that it is not income, but it must be mentioned for the exception to not apply:

*“It would be an unreasonable construction of section 24(2) to hold that it requires the taxpayer to return that as income which he asserts is not income. If, however, he omits all mention of the gain which subsequently is found to be assessable income, section 24(2) will apply. The subsection is not directed to a failure to characterise the advantage as income but the failure to mention it at all. It is the latter omission which enables an amended assessment to be made after the four-year period has expired.”*

The Authority confirmed the Commissioner’s assessments and agreed that a 100% shortfall penalty should also apply to the disputant for taking an abusive tax position.

## ALLOCATED SALARY IMPORTANT WHEN CONSIDERING “OBJECTIVE TEST” IN TAX AVOIDANCE CASES

<b>Case</b>	TRA Decision 4/2010
<b>Decision date</b>	4 February 2010
<b>Acts</b>	Income Tax Act 1994, Tax Administration Act 1994
<b>Keywords</b>	Income splitting, tax avoidance, arrangement and objective test

### Summary

The disputant is an anaesthetist who transferred her private practice to a company in which she was a shareholder. A minimum salary was paid by the company for her services. It was held that an arrangement was in place, which when looked at objectively had a purpose of tax avoidance.

### Impact of decision

The decision appears to follow other Taxation Review Authorities (“TRA”) decisions on section BG1 and emphasises the importance of the allocated salary as a significant part of the “objective test” in income splitting cases. The Court of Appeal is due to hear the *Penny and Hooper* Appeal in February 2010, which decision will become the leading authority on “income splitting” arrangements.



## Facts

The disputant is an anaesthetist in public and private practice. Her husband provided quality assurance services as an employee and privately. On 1 November 2002, the couple restructured their business affairs. One stated reason for the restructuring was to protect their family after concerns were expressed about exposure to claims which could be made by clients against private professional services being provided.

The restructuring involved an arrangement whereby a family trust owned assets including horticultural land, an avocado orchard and business assets relating to the private services provided by the disputant and her husband. A company “W” Limited was established and the disputant and her husband each held a 35% share in the company.

On 1 November 2002, the disputant stopped being self-employed in what Judge Barber saw as “her very profitable private anaesthetist practice” and took up employment in the newly incorporated W Limited, which had taken over the running of her private practice. Her services were then provided to the clients of W Limited, those services being exactly the same as she had been providing when in private practice. However, instead of receiving a substantial income commensurate with her skills and exertions she received no salary from W Limited for 5 months work in 2003 and only \$4,875 in the year ended 31 March 2004 for 12 months work.

The reason given for the lack of salary was that W Limited was not making sufficient income to enable her to be remunerated at the same rate as she had been when in private practice. The avocado orchard business which was owned by W Limited was operating at a loss. One of the larger overheads for the avocado orchard business was the rental paid for the orchard which was owned by the family trust. The disputant claimed that the orchard returns were less than expected due to poor cropping results and lower than expected prices.

As part of his defence the Commissioner drew the attention of the Authority to the fact that W Limited appeared to be paying above normal market rates to lease the orchard. The disputant claimed that rent was not an issue raised by the Commissioner in his Statement of Position and he was therefore excluded from presenting evidence regarding a market rent.

## Decision

### *BG1 and GB1 ITA*

The case is fact specific, with Judge Barber finding that the structures implemented by the disputant left her “unremunerated in a manner which is artificial and contrived and has no sensible reality” (paragraph [23]). The structure was in effect seen as an assignment of her income to the company. It was acknowledged that there are ways in which income from one business activity could be offset against another, but this was not one such situation (paragraph [25]).

Judge Barber acknowledged at paragraph [47] that the leading authority on what constitutes tax avoidance is *Ben Nevis Forestry Ventures Limited v CIR; Accent Management Ltd v CIR*, 24 NZTC 23,188 (SC). He followed the two-step process set out in paragraph [107] of *Ben Nevis*, the first step of which is to determine whether or not the taxpayer has used specific tax provisions within their intended scope.

Having established that step one applies, he notes that a second step considers the use of the specific provisions as a whole and that at this point section BG 1 applies in tandem with the specific provision. At paragraph [48] he quotes from *Ben Nevis* (paragraph [107]) which states:

... a further question arises based on the taxpayer’s use of the specific provision viewed in light of the arrangement as a whole. If, when viewed in that light it is apparent that the taxpayer has used the specific provision, and thereby altered the incidence of tax, in a way which cannot have been within the purpose or contemplation of Parliament when it enacted the provision, the arrangement will be a tax avoidance arrangement.

At paragraph [49] he set out the indicia of when specific provisions under an arrangement will not be within the purpose or contemplation of Parliament. As set out in paragraph [108] of *Ben Nevis*, the indicia include:

1. the manner in which the arrangement is carried out
2. the role of all relevant parties and the relationship they have with the taxpayer
3. the economic and commercial effect of the documents and transactions
4. the duration of the arrangement
5. the nature and extent of the financial consequences of the arrangement
6. the structuring of the arrangement in a contrived and artificial way.

He also acknowledged that the purpose or effect of an arrangement is objectively determined “by looking at the overt acts done in pursuance of the whole arrangement”: *Elmiger and Anor v CIR* [1966] NZLR 683 at paragraph 694;

*CIR v Challenge Corporation Ltd* (1986) 8 NZTC 5,001 at 5,006; *V20* (2002) 20 NZTC 10,233 at pp 37 and 39; *Ashton & Anor v CIR* (1975) 2 NZTC 61,030; *Tayles v CIR* (1982) 5 NZTC 61,311.

At paragraphs [53] and [54] he confirmed that the “effect of an arrangement” will establish its “purpose”. *Tayles, Ashton; Newton v C of T* [1958] AC 45; *V20* and *Westpac Banking Corporation v CIR*, CIV 2005-404-2843, 7 October 2009, HC, Harrison J at paragraph 199.

The Commissioner submitted that the arrangement consisted of several parts including:

1. the incorporation of W Ltd
2. the disputant’s self employment anaesthetist business being transferred to W Ltd
3. the family trust’s anaesthetist business and orchard business being transferred to W Ltd
4. the family trust’s leasing the anaesthetist equipment to W Ltd
5. The family trust’s leasing the orchards, plant and vehicles to W Ltd
6. W Ltd offsetting losses from the orchard business against profits from the anaesthetist business
7. the disputant carrying out the anaesthetist services for W Ltd for no consideration in 2003 and much less consideration than she had previously been receiving in 2004
8. W Ltd failing to adequately remunerate the disputant for anaesthetic services as under the previous contract between the family trust and the disputant due to insufficient company funds.

Judge Barber saw some steps as neutral while steps 2, 6, 7 and 8 were considered significant (paragraph [81]).

At paragraph [82] he agreed with the Commissioner that the tax provisions the disputant was avoiding related to making payment or reward for services income and the payment of tax for personal exertions at a graduated rate. He also acknowledged that income which would ordinarily be the disputants was being “diverted” and taxed at a lower rate than would otherwise be the case.

At paragraph [83] Judge Barber agreed that it is not the formation of the company which is tax avoidance. But rather it is the artificial use of these structures to reduce tax paid in respect of income generated through the disputant’s personal exertions, while retaining full control over and benefit from that income which amounts to tax avoidance.

While agreeing that tax avoidance can be found in individual steps or in a combination of steps at paragraph [84] he states: “**but I consider that the disputant’s transfer**

**of personal exertion income to “W” Ltd for no benefit to her, other than tax savings, is in itself tax avoidance”** [emphasis added].

At paragraph [87] he further states: “... From a commercial perspective, it made no sense for her to agree to receive an artificially low income. The only reason she would agree to such a low income is because an associated entity and trust still controlled the practice income and such income was still available to her and her family by paying debts of “W” Ltd.”

At paragraph [88] Judge Barber looked at Parliamentary Contemplation and stated: “**Parliament would not have contemplated the artificial use of structures to reduce the tax paid in respect of the income generated through the disputant’s personal exertions while, through those structures, she retained full control and benefit from that income”** [emphasis added].

The test of whether or not the tax advantage was “more than merely incidental” is discussed in paragraphs [93] to [99] of the decision. In particular, Judge Barber emphasises paragraph [114] of *Ben Nevis* which states:

[114] ... It will rarely be the case that the use of a specific provision in a manner which is outside Parliamentary contemplation could result in the tax avoidance purpose or effect of the arrangement being merely incidental.

[Emphasis added]

In relation to the ability of the Commissioner to reconstruct the tax affairs of the disputant under section GB 1, Judge Barber noted that the Commissioner has a wide discretion to reconstruct the arrangement to impose tax on the taxpayer. He remained unconvinced as to the proper arithmetical outcome for reconstruction purposes but gave reserve leave for the parties to apply to the TRA for direction should they fail to agree on the correct method for reconstruction.

### 138 G TAA

Judge Barber agreed that the issue of commerciality of the rental charged was not a new issue and referred to a number of paragraphs in the Commissioner’s Statement of Position which sets out various parts of the “arrangement” including leasing from the Family Trust. It was also noted that the disputant raised the issue in evidence about how the accountant set the rental.

Sections 15 and 17 of the Taxation Review Authorities Act 1994 gives the Authority wide powers to accept evidence in a proceeding. The evidence of an expert (in this case a valuer) was held to be admissible under section 25(1) of the Evidence Act 2006.

## APPLICATION TO COMMENCE CHALLENGE PROCEEDING UNDER SECTION 138D OF THE TAX ADMINISTRATION ACT 1994

<b>Case</b>	TRA Decision 05/2010
<b>Decision date</b>	11 February 2010
<b>Act</b>	Section 138D of the Tax Administration Act 1994
<b>Keywords</b>	Exceptional circumstance, judicial review, challenges, dispute

### Summary

Lack of knowledge by the agents of the taxpayers as to the next step in the dispute process, on the facts of this case, and in the circumstances surrounding the issues constituted exceptional circumstance.

### Impact of decision

This decision is largely confined to its own facts. It is doubtful whether this could be a precedent for a more liberal approach to interpretation of section 138D (2) of the Tax Administration Act 1994 (“TAA”).

### Facts

On 4 July 2001 the Commissioner issued a Notice of Proposed Adjustment (“NOPA”) under section 89F of the TAA to the taxpayers, rejecting a GST claim for payments to a subcontractor.

The taxpayers’ Notice of Response (“NOR”) of 3 September 2001 simply asserted that payments were made.

On 4 September 2001 the Commissioner rejected their NOR on the grounds that it did not provide sufficient details to constitute a valid NOR.

On 23 October 2001 the Commissioner issued notices of assessments according to the adjustments as per his NOPA.

On 22 March 2007 the taxpayers applied for judicial review of the Commissioner’s decision rejecting their NOR.

At the hearing in the High Court, Woodhouse J held that the taxpayers’ NOR was valid and the Commissioner had no power under the dispute process to reject the taxpayers’ NOR.

The Commissioner appealed to the Court of Appeal which held that Woodhouse J was wrong in granting the judicial review even though he was right on the point that the Commissioner had no power to reject the NOR. The proper course of action for the taxpayers was to proceed to challenge the assessments before the Taxation Review Authority (“TRA”) and not by way of judicial review.

On 8 September 2009, the taxpayers filed their Notice of Claim with the TRA, which was treated as an application under section 138D of the TAA for commencement of a challenge out of time.

### Decision

Judge Barber at paragraph [25] held that the knowledge of what to do next in the tax dispute was not clear at the time. It required the Court of Appeal to clarify the way forward. Such knowledge as to what to do next was not within the accepted standard of the professional conduct of the agents of the taxpayers. There were therefore exceptional circumstances under section 138D(2).

## COMPROMISE PROPOSALS FAIL TO CONVINCE COURT

<b>Case</b>	CIR v Atlas Food & Beverage Ltd & Ors; FM 1 Ltd & Ors v CIR
<b>Decision date</b>	24 February 2010
<b>Act</b>	Companies Act 1993
<b>Keywords</b>	Compromise, creditors, class, liquidation, secured

### Summary

There were a number of significant irregularities in the debtor companies’ compromise proposals. The Court held that it was not appropriate to ratify or grant compromises in these circumstances.

### Impact of decision

The decision is a helpful and thorough analysis of the various creditors’ compromise provisions of the Companies Act 1993.

### Facts

This summary is in respect of two related decisions that were delivered contemporaneously. The *FM 1* decision is a companion judgment to the *Atlas* decision, and the two decisions should be read together. The proceedings were in respect of compromises proposed by the companies with their creditors under Part 14 and/or 15 of the Companies Act 1993 (“the Act”).

The proceedings involve seven companies owned and controlled by the same person. Four of the companies (the *Atlas* companies) are involved in the hospitality industry. The other three (the *FM 1* companies) are no longer trading, but were previously property-owning companies.

The Commissioner applied to liquidate each of the companies on the grounds that they were unable to pay their debts. The companies then proposed compromises with their creditors under Parts 14 and/or 15 of the Act.

### *Atlas companies*

The Commissioner had a number of concerns with the compromises:

- He was classified together with secured creditors, which was inappropriate.
- A secured creditor's debt was grossly overstated, and was contingent.
- A number of companies related to the Atlas companies were permitted to vote on the compromises.
- The timeframe for payment was too long and that the likelihood of payment was uncertain.
- The compromises purport to contract out of the statutory interest (ie UOMI) and penalty regime.
- The terms of the compromises were irreconcilable with the Commissioner's obligation to uphold the integrity of the tax system.

The Commissioner voted against the compromises, but the compromises were purportedly accepted by the creditors in relation to two of the four companies. The compromises were rejected by creditors in relation to the other two companies.

The Commissioner applied for orders under section 232 of the Act that he not be bound by the two compromises that were purportedly passed, on the grounds that there were material irregularities in the compromises and/or the compromises were unfairly prejudicial to the Commissioner.

The four Atlas companies each applied to the Court for orders under section 236 of the Act approving the compromises.

### *FM 1 companies*

The Commissioner had a number of concerns with the FM 1 companies' compromises. While there were multiple creditors, the only creditor whose debt was being compromised was the Commissioner. The other creditors were to take no part in the compromise, and receive nothing under it. They retained all their rights. Additionally:

- the compromises provided that penalties and interest would not accrue on the outstanding debt which was not possible;
- the debts owed to the Commissioner arose from transactions which indicated a cynical disbursement of proceeds to defeat the Commissioner's claims;
- the Court and the Commissioner could have no confidence that the compromises would be performed on their terms because of the "untidy" way in which the

proposals were presented and advanced and because of the commercial uncertainty surrounding the proposed repayment arrangement over a five-year time frame;

- that the affairs of the three applicant companies and the actions of their directors in and about August 2008 warranted investigation and this was best able to be achieved through the making of liquidation orders and the appointment of liquidators;
- public policy considerations militated against granting the applications as each of the three companies was insolvent, with no recent trading history and no legitimate interest to protect;
- the proposal to pay \$1,000,000 over a five-year time frame represented only a modest proportion of the core debt (about 62%).

A meeting of creditors was scheduled to consider and vote on the proposed compromises. After the Commissioner drew the companies' attention to apparent defects in the compromises, the meeting was cancelled. The companies then applied for orders under section 236 of the Act that the compromises be approved.

### **Decision**

#### *Material irregularities with Atlas companies' applications*

The Court was satisfied that the Atlas companies' applications were affected by material irregularities. In particular, the Court held that the Commissioner as a preferred creditor should not have been placed with secured creditors but in a separate class; that a large-contingent creditor should have been placed in a separate class (not the secured class) and should have had the value of its debt (incorrectly stated) discounted; that related parties who were not to receive anything under the compromise should have been separately classified and their votes discounted in full.

#### *Compromises unfairly prejudicial to the Commissioner*

Based upon the findings made regarding material irregularities and the overlap with the section 236 arguments, the Court had no difficulty in establishing that the compromises were unfairly prejudicial to the Commissioner and he could not be bound by them.

#### *Atlas companies' section 236 applications*

The Court was not persuaded to grant the Atlas companies' section 236 applications. The Court held inter alia that aside from the Atlas and Schwartz (one of the other applicants) applications being tainted by material irregularity pursuant to section 232 the four section 236

applications failed due to a lack of reliable evidence. The Court was reasonably scathing about the manner in which the applications had been presented:

[74] The findings I have already made in relation to material irregularities remain relevant in the present context. For the reasons already discussed I do not consider there is reliable evidence available as to the true level of creditor support for the compromises. In addition, the section 236 applications have been presented in a most informal manner. Creditors are not directly apprised of the revised terms of the compromises, rather they have been invited to make further inquiry if they see fit. Mr Forbes argued that because the amendments serve to improve the proposed terms of compromise the process employed should not be viewed as a matter of concern. I do not agree. To my mind I am being asked to approve four compromises absent a proper and adequate opportunity for creditors to have an informed input.

The Court also held grave concerns regarding the continuing role played by the director of most, if not all, of the relevant companies. The Commissioner argued that of the 64-odd companies presently registered with Inland Revenue under his control, 90% of income tax returns from those 64 companies were outstanding. In response to defaults by these companies, the Commissioner had issued 28 statutory demands and filed 13 liquidation proceedings, in addition to filing 44 District Court applications seeking orders requiring various companies to file overdue returns. The Court's view on the suitability of the director's control of the relevant companies particularly as it related to overseeing the proposed repayment proposal was stark:

[95] In my view [his] position as the director of all relevant companies and as the person responsible for the implementation of the compromise proposals, is untenable.

#### *FM 1 companies section 236 applications*

The Court formed a clear view that the proposals should not be approved, essentially because it would not be fair and equitable to do so. The Court was influenced by the following matters:

- Where a solitary creditor is affected by a compromise and it is proposed that he should only receive a proportion of his debt, there would need to be highly persuasive considerations in favour of the applicant company continuing in existence before approval would be appropriate.
- There weren't any good reasons for not liquidating the applicant companies.
- The Court viewed that the affairs of the applicant companies warranted investigation which may be best achieved by liquidation.

## REGULAR CONTRIBUTORS TO THE TIB

### Office of the Chief Tax Counsel

The Office of the Chief Tax Counsel (OCTC) produces a number of statements and rulings, such as interpretation statements, binding public rulings and determinations, aimed at explaining how tax law affects taxpayers and their agents. The OCTC also contributes to the “Questions we’ve been asked” and “Your opportunity to comment” sections where taxpayers and their agents can comment on proposed statements and rulings.

### Legal and Technical Services

Legal and Technical Services contribute the standard practice statements which describe how the Commissioner of Inland Revenue will exercise a statutory discretion or deal with practical operational issues arising out of the administration of the Inland Revenue Acts. They also produce determinations on standard costs and amortisation or depreciation rates for fixed life property used to produce income, as well as other statements on operational practice related to topical tax matters.

Legal and Technical Services also contribute to the “Your opportunity to comment” section.

### Policy Advice Division

The Policy Advice Division advises the government on all aspects of tax policy and on social policy measures that interact with the tax system. They contribute information about new legislation and policy issues as well as the Orders in Council.

### Litigation Management

Litigation Management manages all disputed tax litigation and associated challenges to Inland Revenue’s investigative and assessment process including declaratory judgment and judicial review litigation. They contribute the legal decisions and case notes on recent tax decisions made by the Taxation Review Authority and the courts.

## GET YOUR TIB SOONER ON THE INTERNET

This *Tax Information Bulletin (TIB)* is also available on the internet in PDF at [www.ird.govt.nz](http://www.ird.govt.nz)

The *TIB* index is also available online at [www.ird.govt.nz/aboutir/newsletters/tib/](http://www.ird.govt.nz/aboutir/newsletters/tib/) (scroll down to the bottom of the page). The website has other Inland Revenue information that you may find useful, including any draft binding rulings and interpretation statements that are available.

If you would prefer to get the *TIB* from our website, please email us at [tibdatabase@ird.govt.nz](mailto:tibdatabase@ird.govt.nz) and we will take you off our mailing list.

You can also email us to advise a change of address or to request a paper copy of the *TIB*.