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TAX INFORMATION Bulletin

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Inland Revenue
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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.

You can find a list of the items we are currently inviting submissions on as well as a list of expired items at **taxtechnical.ird.govt.nz** (search keywords: public consultation).

Email your submissions to us at **public.consultation@ird.govt.nz** or post them to:

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

You can also subscribe at **ird.govt.nz/subscription-service/subscription-form** to receive regular email updates when we publish new draft items for comment.

Your opportunity to comment

Ref	Draft type	Title	Comment deadline
PUB00340	Question we've been asked	GST and income tax – payments made by parents to childcare centres	7 February 2023
PUB00443	Question we've been asked	Foreign investment fund (FIF) default calculation method	10 February 2023
PUB00392	Interpretation statement	Charities – business income exemption	17 February 2023

IN SUMMARY

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Legal Decisions - case summaries

NEW LEGISLATION

This section of the *TIB* covers new legislation, changes to legislation including general and remedial amendments, and Orders in Council.

Order in Council – Tax Administration (Regular Collection of Bulk Data) Regulations 2022

Section 17L(2) Tax Administration Act 1994

Order

The Tax Administration (Regular Collection of Bulk Data) Regulations 2022 allows the Commissioner of Inland Revenue to collect datasets from Payment Service Providers on a regular basis and sets 1 April 2023 as the beginning of the first reporting period for the regulations.

Background

Before the enactment of section 17L of the Tax Administration Act 1994 (TAA), data requests were made by the Commissioner of Inland Revenue to Payment Service Providers (PSPs) on an ad hoc basis under section 17B of the TAA. This was a resource-intensive way for the Commissioner to collect the required datasets.

Section 17L of the TAA allows for the regular collection of bulk datasets by Order in Council. The Tax Administration (Regular Collection of Bulk Data) Regulations 2022 allows the Commissioner to collect datasets from PSPs on a regular basis. These datasets will form a database that will support improved compliance and detect those operating in the hidden economy.

Section 17L sets out the ability to define the class of persons the regulations will apply to and defines the scope the datasets.

Key features

Who is affected

The regulations set out the definitions of who will be affected and what data they are required to supply, including both merchant and transaction details.

A PSP is a business that participates in a payment system by facilitating payments for goods and services between customers and merchants.

These businesses include:

- merchant acquirers
- entities who provide switch services
- entities who provide settlement services
- entities who provide online payment gateways
- entities who provide alternative payment methods.

An entity that is an issuer (for example, the customer's bank that issues a payment card) or a business that provides payment service hardware is not included, except to the extent that the business also provides an included service.

The Commissioner of Inland Revenue has taken notable steps to advise the PSPs that are affected. However, there may still be some entities that meet the requirements and have not been notified. These entities are still subject to the reporting obligations as outlined in the regulations. Examples of who will be affected will be added to the Inland Revenue website over time.

Reporting the datasets

Beginning from 1 April 2023, the annual datasets provided are to consist of aggregate monthly merchant transactions for the 6-month periods of 1 April to 30 September and 1 October to 31 March. These datasets are due to be reported to the Commissioner one month and seven days after the conclusion of the reporting period, being 7 November and 7 May.

The first reporting period

The regulations came into force on 15 December 2022. The first reporting period will commence on 1 April 2023 and conclude on 30 September 2023 with the datasets due to Inland Revenue by 7 November 2023.

Exemptions

Some PSPs may be eligible for an exemption. All information and required forms are available on the Inland Revenue website. Getting an exemption (**ird.govt.nz/topics/intermediaries/payment-service-providers/getting-an-exemption**)

Steps to be taken before criminal proceedings brought

The Commissioner must, before deciding whether criminal proceedings should be brought for a failure to comply with these regulations, notify the PSP of the due date for the provision of the information, communicate with the PSP to find out why the information has not been provided, and in particular if there are impediments delaying or preventing its provision, and advise the PSP of the consequences of not providing the information to the Commissioner.

Defenses in any proceedings relating to failure to comply with this order

Where a PSP is required to provide information to the Commissioner under these regulations and fails to do so, they have a defence in any proceedings where they can prove that they took all reasonable steps to provide correct and complete information required by these regulations. No penalty may be imposed in relation to the failure to provide information or complete information.

Further information

The new regulations can be found at:

https://www.legislation.govt.nz/regulation/public/2022/0295/latest/whole.html

Further information about the legislation can be found at:

ird.govt.nz/topics/intermediaries/payment-service-providers

Order in Council – Income Tax (Fringe Benefit Tax, Interest on Loans) Amendment Regulations (No 2) 2022

Sections RA 21(3) and (4) of the Income Tax Act 2007

Order

The Income Tax (Fringe Benefit Tax, Interest on Loans) Amendment Regulations (No 2) 2022 was made on 21 November 2022. The Order changes the prescribed rate of interest for calculating fringe benefit tax on low-interest loans provided by an employer to an employee.

The fringe benefit tax (FBT) prescribed rate of interest for low-interest employment-related loans has been increased from 4.78% to 6.71 % in line with recent changes in market interest rates.

Background

The FBT rules tax non-cash benefits provided to employees. Included in the definition of 'fringe benefit' is any employment-related loan on which the employer is charging a rate of interest that is below the market rate. The interest differential is taxable. A prescribed rate set by regulations is used as a proxy for the market rate of interest to save employers the compliance costs associated with determining the market rate relevant to loans they have provided to their employees.

Section RA 21(3) of the Income Tax Act 2007 permits the making of regulations by Order in Council to set a prescribed rate of interest for calculating FBT on low-interest loans. Once a rate is set, it remains the prescribed rate until changed by a subsequent Order in Council.

By administrative convention, the FBT prescribed rate of interest is based on the 'floating first mortgage new customer housing rate' series published by the Reserve Bank (RBNZ) each month. It is updated when there has been an increase or decrease in the RBNZ rate of 20 or more basis points since the FBT rate was last set. The RBNZ rate for August 2022 was 6.71%. This is up from 4.78%, the rate for January 2022, which the most recent FBT prescribed interest rate was based off. The FBT prescribed rate of interest is being lifted accordingly.

Effective date

The new prescribed rate of 6.71% applies for the quarter beginning 1 January 2023 and subsequent quarters.

Further information

The regulations updating the prescribed rate of interest can be found at:

https://www.legislation.govt.nz/regulation/public/2022/0306/latest/whole.html

Order in Council – Taxation (Use of Money Interest Rates) Amendment Regulations (No 3) 2022

Sections 120E(1) and 120H of the Tax Administration Act 1994

Order

The Taxation (Use of Money Interest Rates) Amendment Regulations (No 3) 2022 Order in Council was made on 24 November 2022. The Order changes the use of money interest (UOMI) rates on underpayments and overpayments of taxes and duties in line with market interest rates. The new underpayment rate is 9.21% (previously 7.96%). The new overpayment rate is 2.31% (previously 1.22%).

Background

The UOMI underpayment rate is charged to taxpayers on underpayments of their liability to Inland Revenue, while the UOMI overpayment rate is paid to taxpayers on money paid to Inland Revenue exceeding their liability.

Section 120H(1)(b) of the Tax Administration Act 1994 permits the making of regulations by Order in Council to set the UOMI underpayment and overpayment rates. Once a rate is set, it remains at that rate until changed by a subsequent Order in Council.

The UOMI underpayment rate is based on the 'floating first mortgage new customer housing rate' series published by the Reserve Bank (RBNZ) each month, while the UOMI overpayment rate is based on RBNZ's '90-day bank bill rate' series each month. The UOMI rates are both adjusted if either the RBNZ 90-day bank bill rate or the floating first mortgage new customer housing rate moves by 1% or more, or if one of these indexes moves by 0.2% or more and the UOMI rates have not been adjusted in the last 12 months.

The UOMI rates are adjusted as required to ensure they are in line with market interest rates. The new UOMI rates are consistent with the floating first mortgage new customer housing rate and the 90-day bank bill rate.

Effective date

The new UOMI rates apply on and after 17 January 2023.

Further information

The regulations updating the use of money interest rates can be found at

https://legislation.govt.nz/regulation/public/2022/0315/latest/whole.html

Order in Council – Student Loan Scheme (Repayment Threshold for 2023–24 Tax Year and Subsequent Tax Years) Regulations 2022

Section 215(1)(a) of the Student Loan Scheme Act 2011

Order

These regulations, which come into force on 1 April 2023, increase the annual repayment threshold for the purposes of the Student Loan Scheme Act 2011 from $21,268 to $22,828.

Key features

These regulations also revoke the Student Loan Scheme (Repayment Threshold) Regulations 2021.

Background

The student loan repayment threshold is the amount of annual income a New Zealand-based borrower can earn before being required to make repayments on their outstanding student loan balance. Under current policy, the student loan repayment threshold is adjusted for inflation annually.

From 1 April 2023, New Zealand based borrowers must make student loan repayments on income above $22,828. This is an increase from the 2022-23 tax year threshold of $21,268.

In previous years, this adjustment was calculated using a consumer price index (CPI) figure that excluded tobacco products. In November 2022, Cabinet agreed to return to a CPI measure which includes tobacco products, reflecting the government-wide approach to indexation. This calculation method applies from the 2023-24 tax year onwards.

Effective date

The new repayment threshold applies from 1 April 2023.

Further information

The new repayment threshold applies from 1 April 2023.

https://legislation.govt.nz/regulation/public/2022/0316/latest/whole.html

Order in Council – Tax Administration (Extension of Deadline for Research and Development Loss Tax Credit Statements) Order 2022

Section 70C(1) Tax Administration Act 1994

Order

The Tax Administration (Extension of Deadline for Research and Development Loss Tax Credit Statements) Order 2022 was made on 19 December 2022 and came into force on 22 December 2022. The Order extends the deadline for filing a statement required under section 70C(1) of the Tax Administration Act 1994 for the 2021–22 tax year until 30 April 2023.

Background

Research and Development loss tax credits (R&DLTCs) allow loss-making taxpayers undertaking R&D to "cash out" their losses. This provides a timing benefit to the taxpayer, but those losses then cannot be used to shelter future income once the taxpayer is profitable. It is an R&D support measure that supports the cashflow position of new R&D businesses, as they otherwise might not be able to receive the tax benefit of those losses until several years in the future.

To be eligible to claim R&DLTCs for a year, a taxpayer must submit a statement as required by section 70C(1) of the Tax Administration Act 1994. The due date for this statement is provided for in section 70C(2), with the due date in any year being the earlier of:

- The day on which the taxpayer files a return of income, and
- The last day for filing a return of income.

In practice, the former of the above two limbs will tend to be the binding due date. This can be problematic if the taxpayer inadvertently files their income tax return at least a day before they file an R&DLTC statement. Under the current legislative settings, that taxpayer would be ineligible for R&DLTCs for the year. This is true even if both the return and the R&DLTC statement are filed well in advance of the actual due date for the income tax return. This outcome is counter to the intent of the R&DLTC regime, where businesses have an incentive to file their income tax return early to be able to cash out their losses sooner.

Extension of deadline for R&D loss tax credit statements

The Tax Administration (Extension of Deadline for Research and Development Loss Tax Credit Statements) Order 2022 counteracts the timing issue mentioned above, for the 2021–22 tax year, by allowing the statement to be filed as late as 30 April 2022, regardless of the date of filing of the income tax return. The Order is made under section 226 of the Tax Administration Act 1994. That section allows for extensions of time to be granted by Order in Council to meet requirements under some of the Inland Revenue Acts, even when the deadline has already expired.

Effective date

The Order came into force on 22 December 2022.

Further information

The Order can be found at:

https://legislation.govt.nz/regulation/public/2022/0342/latest/whole.html

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 *Binding rulings: How to get certainty on the tax position of your transaction (IR715)*. You can download this publication free from our website at **www.ird.govt.nz**

BR Prd 22/14

This is a product ruling made under s 91F of the Tax Administration Act 1994.

Name of person who applied for the Ruling

This Ruling has been applied for by Bank of New Zealand (BNZ).

Taxation Laws

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

This Ruling applies in respect of:

- ss BG 1, CC 7, EW 15, EW 31, RE 1, RF 1; and;
- ss 86F and 86I of the Stamp and Cheque Duties Act 1971 (SCDA).

The Arrangement to which this Ruling applies

The Arrangement is a product (TotalMoney) that BNZ offers to its customers. These customers may only be individuals, companies, or trusts.

TotalMoney involves the creation of specific accounts that must be in a group of accounts, and the facility for customers to elect to group up to 50 of these specific accounts into one or more groups to either "pool" or "offset" the account balances.

"Pooling" involves the aggregation of account credit balances to determine the tiered interest rate that will apply to the calculation and crediting of interest to each account balance. "Offsetting" involves the aggregation of account balances to calculate the amount of interest debited to a lending facility account balance.

The Arrangement is set out in the documents listed below, copies of which were received by the Tax Counsel Office, Inland Revenue, on 29 June 2022 and 1 November 2022:

- Terms and Conditions for your Bank of New Zealand TotalMoney Account for Personal and Sole Trader Customers;
- Terms and Conditions for your Bank of New Zealand TotalMoney Account for Companies and Trusts;
- Bank of New Zealand Home Loan Facility Master Agreement;
- Letter of Advice – TotalMoney Home Loan;
- Facility Document – TotalMoney Business Term Loan; and
- BNZ Business Lending Master Terms and Conditions.

While the Letter of Advice will be personalised for each customer's circumstances, contracts under the Arrangement are between arms-length parties operating on standard contractual terms.

Changes will be made to some aspects of the Arrangement from 31 October 2022 to:

- remove the credit interest paid on credit balances for existing and new TotalMoney accounts;
- remove the fees for existing and new accounts for personal TotalMoney customers;
- remove TotalMoney "pooling"; and
- retain the fees for existing TotalMoney for Business accounts, with the potential to remove this fee in the future.

The Terms and Conditions for your Bank of New Zealand TotalMoney Account for Personal and Sole Trader Customers and the Terms and Conditions for your Bank of New Zealand TotalMoney Account for Companies and Trusts will change from 31 October 2022 to address the removal of "pooling" and interest paid on credit balances under "pooling" and/or "offsetting" and to set out the changes in fees.

These changes are set out in BNZ's website (Public Notices – BNZ) under ***Changes to TotalMoney terms and conditions (effective 31 October 2022)***.

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

1) TotalMoney is a package of accounts and loans that BNZ offers to its customers. These customers may only be individuals, companies, or trusts.
2) Customers in general have a range of accounts with BNZ, including transaction accounts, savings accounts, and various loan accounts. Loan accounts may be only table, non-table, tailored, principal and interest, interest only, fixed or floating home loan accounts, or business loan accounts.
3) TotalMoney allows customers to group or aggregate these accounts for the purposes of either "pooling" or "offsetting" the account balances.

Primary features of TotalMoney

4) The primary features of TotalMoney are the "pooling" and "offsetting" features. These features operate in the manner described below.

   Pooling until 31 October 2022

   a) The pooling aspect of TotalMoney operates when several transaction accounts with credit balances exist. Interest on these credit balance accounts is calculated and paid based on the cumulative credit balance of all transaction accounts in the group. Interest-bearing accounts usually attract interest based on interest rate brackets that apply to the balance of each relevant individual account.

   b) The cumulative credit balance is calculated so BNZ can ascertain the relevant interest rate tier applicable to the relevant accounts. The separate funds are not actually transferred to one account before the interest is calculated. BNZ calculates interest at the applicable interest rate tier that applies to the accumulated balance.

   Offsetting

   a) With the offset feature of TotalMoney, interest on a lending facility or facilities within the group is calculated and paid by the customer on the difference between the lending facility balances and the credit balances of transaction accounts in the group. Under the terms and conditions agreed between BNZ and its customers for TotalMoney, BNZ pays no interest on the credit balances that are "offset" against the lending facility.

   b) The "offsetting" is only to calculate the balance of the lending facility or facilities on which interest is payable, or, where the credit balances of transaction accounts exceed the balance of the lending facility or facilities in the group of which the credit balances are "offset" against, the balance of the excess credit balances on which interest is receivable. There is no actual transfer of funds, no set-off or netting of funds together in an account, and no transfer of any interest in or entitlement to funds.

Pooling and interest on credit balances from 31 October 2022

a) TotalMoney for Business lending is no longer available to new business customers. Existing TotalMoney for Business customers can remain in a group but no interest will be paid on the credit balances of the group accounts or the "offsetting" accounts.

b) While grouping TotalMoney transactional accounts will still be available, there will be no interest paid on the credit balances of the group accounts or the "offsetting" accounts.

c) TotalMoney transactional accounts without TotalMoney home loans will no longer be available to new customers from 31 October 2022.

d) BNZ will review all existing pooling customers and will be encouraging them to transfer to other products that are more suitable for savings accounts and their needs.

5) Every transaction account in a TotalMoney group is automatically set to "pool" or "offset". If a customer has any lending facilities within their TotalMoney group, the customer's transaction accounts with credit balances are "offset" against their lending facilities. Interest is payable by the customer if the balance of their lending facilities exceeds the balance of their transaction accounts with credit balances, and until 31 October 2022, interest is payable by BNZ if a customer's transaction accounts with credit balances exceeds the balance of their lending facilities. Where the customer has no loan account(s), a customer's TotalMoney accounts will automatically group.

6) TotalMoney does not provide a facility for other accounts. Instead it involves creating a specific type of account. To participate in TotalMoney, a customer must open specific TotalMoney accounts that are particular to the TotalMoney product, or a customer may convert an existing BNZ account to a new TotalMoney account. However, the customer must agree that the existing terms and conditions that apply to those accounts cease to apply, and are replaced by the TotalMoney Terms and Conditions.

7) For new TotalMoney accounts, the account will be set to "offset".

Pooling – further detail

8) Until the changes are made to the credit interest aspect of TotalMoney from 31 October 2022, BNZ has a contractual obligation to pay interest if either a customer's transaction accounts with credit balances exceeds their lending facilities within a TotalMoney group, or a customer only has transaction accounts with credit balances (and no lending facilities) within a TotalMoney group. The interest payable is based on the applicable interest rate tier that applies based on the total credit balance being "pooled" or "offset" against any lending facilities in the TotalMoney group. Following usual business practice, BNZ makes a separate determination for withholding tax on each interest payment made to each account.

9) The benefit of the "pooling" feature for customers is that they can earn more interest by combining smaller balances and reaching higher interest-rate tiers and still maintain their money in separate accounts for separate purposes. The customer may consider this an advantageous way to manage their money.

10) Account owners have full deposit and withdrawal access to their transaction accounts. Overdraft facilities may be available in relation to these accounts. However, any overdraft balance is ignored for "pooling" purposes. BNZ charges debit interest on the overdrawn balance of any account. The overdrawn balance does not reduce the "pooled" balance of the credit balance accounts when BNZ is calculating interest for those accounts.

11) BNZ will be removing "pooling" and the payment of interest on credit balances from 31 October 2022. This is as part of the replacement of BNZ's core banking systems and is intended to simplify products to customers. As part of its plans for the future, BNZ will be encouraging customers who have credit balances to transfer to a different type of account that has appropriate rates of interest and are better suited to their needs.

12) BNZ will also be reconsidering its fees for the TotalMoney product. It will remove the fee for all personal customers with TotalMoney accounts around the same time the change to credit interest is made. The fee for TotalMoney business customers will remain for the time being, and may be removed at some point in the future.

Offsetting – further detail

13) Where a customer has a TotalMoney loan account, this account will generally be grouped with at least one other TotalMoney transaction account. There must be at least one loan account in the group, and may be more at BNZ's discretion.

14) Where one loan account is in the group, the interest payable on the loan account is calculated on the balance of the loan account less the credit balances of accounts in the group. This will be the case as a matter of law (in terms of TotalMoney documentation) and as a matter of practice (in terms of BNZ's computer system). There is no actual set-off, netting, or transfer of funds, or transfer of any interest in or entitlement to funds. "Offsetting" occurs before debit or credit interest is calculated.

15) For example, in the case of a loan account that would otherwise be the same as a standard variable rate table home loan facility over 30 years with a "minimum payment", there will be no provision for the amount of interest saved under "offsetting" to reduce the "minimum payment". The effect of "offsetting" is the same as a decrease in the floating interest rate and a decision not to reduce the amount of the "minimum payment". In either case, the term of the loan is reduced because the principal portion of the payment is effectively increased. In the case of a non-table loan, interest payments will be reduced by "offsetting", principal repayments will not change, and the loan term will not reduce. In the case of interest only loans, repayments comprise solely interest, so the impact of "offsetting" will be to reduce the interest amount and therefore reduce the "minimum payment".

16) Where there is more than one loan account in the group, the loan accounts in the group are given a default priority; namely, the oldest loan account in the group will receive the highest priority. However, the customer may elect two or more of those loan accounts to be prioritised for "offsetting" purposes. The loan account with the highest priority will receive the benefit of "offsetting" first. It is only where the credit balances of transaction accounts in the group exceed the balance of that highest priority loan account that the next highest priority loan account balance is offset, and so on.

17) Until the changes are made to the credit interest aspect of TotalMoney, if the total credit balances of the transaction accounts are greater than the total debit balance of the loan accounts in a group, credit interest will be applied to the difference. Interest is then paid on a prorated basis to the credit balance accounts in accordance with the balance of those accounts (essentially in line with the "pooling" feature of TotalMoney).

18) BNZ will be removing the payment of interest on credit balances from 31 October 2022. As discussed at 11), this is as part of a replacement of BNZ's core banking systems and is intended to simplify products to customers.

19) BNZ calculates interest daily. If, during a month, BNZ has both an entitlement to receive interest (that is, the balance of participating loan accounts exceeds the balance of all transaction accounts in a group) and, at another point in the month, BNZ has an obligation to pay interest (that is, the balance of transaction accounts in a group exceeds the balance of the relevant loan accounts), then the two interest payments are made and are not set-off.

20) The "offsetting" feature of TotalMoney essentially offers the same benefits to customers as offered by a revolving credit loan (such as BNZ's "Rapid Repay" product) in terms of lower interest costs and a shorter time to repay the loan. However, this feature overcomes a primary perceived disadvantage of a revolving credit loan because it allows customers to retain separate account balances (which customers may prefer when managing their finances).

21) No arrangement must exist between the customers who have grouped their accounts that provides for the loan account owner(s) to make a payment(s) to the transaction account owner(s) in consideration for the transaction account owner(s) "offsetting" their accounts under TotalMoney.

Business purposes

22) When TotalMoney was established, customers were contractually prohibited from using TotalMoney for business purposes. BNZ later removed the prohibition on the business use of TotalMoney. BNZ extended the availability of TotalMoney to business customers to give them the same tools for managing their financial affairs as it gives to personal customers.

23) Under the terms and conditions applicable to TotalMoney, customers were able to use TotalMoney accounts for business purposes. This means that, customers, such as sole traders, could group business and non-business product accounts.

24) On 1 November 2019, BNZ stopped offering TotalMoney for Business lending for sale and intends to keep this off-sale. However, there are existing TotalMoney for Business customers who have not yet transferred to a different product.

25) In August 2022 BNZ stopped offering new TotalMoney home lending to non-natural persons (such as trusts and look-through companies). However, existing TotalMoney home loans for these customers at the date of this Ruling remain as is.

Terms and Conditions for the TotalMoney home loan products

26) The TotalMoney product home loans are documented primarily in a Home Loan Facility Master Agreement, and personalised Letter of Advice. The relevant TotalMoney Account Terms and Conditions (i.e. either for Personal & Sole Trader or Trusts and Companies) also apply as a separate contract to the TotalMoney Home Loan contract.

27) Table loans provide for regular payments and a set date when they will be paid off. Most payments early in the loan term comprise interest, while most of the payments later in the term comprise repayments of the principal. Non-table loans have two separate repayments, one of interest and one of principal. Customers repay the same amount of principal each time and interest is charged separately.

28) The documentation for a TotalMoney standard variable rate table home loan facility over 30 years is largely the same as that for current BNZ home loan facilities that are standard variable rate table home loans over 30 years. The only differences are; branding (the name on the Letter of Advice), the interest calculation (which provides for the effect of the "offset"), and, in relation to table loans, the provision stating that where the loan has the benefit of the "offset" to reduce the interest cost, the "minimum payment" specified for the loan will not decrease because of any interest savings but instead the loan term will reduce.

29) Under a non-table loan, any interest saving (whether as a result of a reduction in the applicable interest rate because of a general decrease in interest rates, or because of the offset feature) would result in either a reduction of the interest repayment or a reduction in the loan term (if the original repayment amount is maintained despite the interest saving). In relation to a TotalMoney product home loan that is a table home loan, a reduction is only allowed in the loan term. Under a TotalMoney product interest only loan, any interest saving (whether as a result of a reduction in the applicable interest rate because of a general decrease in interest rates, or because of the offset feature) would result in a reduction of the interest repayment.

Terms and conditions for TotalMoney business loan products

30) The TotalMoney business loans are documented primarily in the Facility Document – TotalMoney Business Term Loan and other Ancillary documents. The business loans are also subject to the relevant BNZ Business Lending Master Terms and Conditions. As previously stated at 24), BNZ stopped offering TotalMoney for Business lending for sale from 1 November 2019.

Groups

31) TotalMoney is based on a group of participating accounts. Groups can be comprised of only the following categories:

a) Natural persons:

i) The accounts of an individual, or the individual and joint accounts of married, de facto, and civil union couples, and any of their children may be combined as part of one group of accounts.

ii) For example, the various accounts of one natural person, Jane, or, the various accounts (individual or joint) of Jane and her husband John and their child Joe. The group is not limited to residents of New Zealand, although the group may not include both residents and non-residents.

b) One company or one trust:

i) Multiple accounts of one company (including a qualifying company or look through company) or one trust may be combined as part of a group. Only one entity can be in a group at any time.

ii) Accounts of different entities (including the entity and any related individual) cannot be pooled or offset.

32) Accounts may only be included in one group. An individual may have accounts in three groups, through membership in one as an individual customer, the second as a joint customer and in the third as a sole trader. A group may not include more than one sole trader's accounts.

33) A customer may be a resident or non-resident of New Zealand for tax purposes. However, where a group of accounts consists of accounts owned by more than one legal person, BNZ will obtain representations from the owners of those accounts that they do not have different tax residence status. That is, where more than one legal person is participating in a group of accounts, either all persons must be residents of New Zealand for tax purposes or all persons must be non-residents of New Zealand for tax purposes.

BNZ's objectives

34) BNZ's objectives in providing TotalMoney are to:

a) increase its market share, particularly for home loans and transaction-type accounts;

b) increase customer satisfaction and customer retention;

c) ensure customers are using the most appropriate product for their needs; and

d) improve its brand awareness and be seen as a market leader.

How the Taxation Laws apply to the Arrangement

The Taxation Laws apply to the Arrangement as follows:

Financial arrangements rules

a) When a credit balance of a transaction account and a debit balance of a loan account are "offset", there is no amount of consideration paid or payable because of that "offset" for the calculation of income and expenditure under ss EW 15 and EW 31 of the "financial arrangements rules" (as defined in s EW 1(2)).

Resident Withholding Tax (RWT), Non-Resident Withholding Tax (NRWT) and Approved Issuer Levy (AIL)

b) Under the "pooling" feature of TotalMoney:

i) RWT (as defined in s YA 1) and NRWT (as defined in s YA 1) must be deducted by BNZ from the interest credited (if any) to the participating transaction accounts in a group in accordance with the RWT rules (as defined in ss RE 1(1) and YA 1) and the NRWT rules (as defined in ss RF 1(1) and YA 1);

ii) For an account that is a "registered security" (as defined in s 86F of the SCDA), "approved issuer levy" (as defined in s 86F of the SCDA) may be paid by an "approved issuer" (as defined in s 86F of the SCDA) for the interest credited (if any) to that account pursuant to s 86I of the SCDA.

c) Under the "offsetting" feature of TotalMoney:

i) There is no payment of or entitlement to "interest" (as defined in s YA 1) for the credit balances of participating transaction accounts in a group, and no obligation to deduct RWT or NRWT or pay AIL, except to the extent that the combined credit balance of those accounts exceeds the combined debit balance of the lending facility accounts prior to the changes being made.

ii) To the extent that any interest is credited to participating transaction accounts in a group:

A) RWT (as defined in s YA 1) and NRWT (as defined in s YA 1) must be deducted by BNZ from the interest credited to the participating transaction accounts in a group in accordance with the RWT rules (as defined in ss RE 1(1) and YA 1) and the NRWT rules (as defined in ss RF 1(1) and YA 1);

B) For an account that is a "registered security" (as defined in s 86F of the SCDA), "approved issuer levy" (as defined in s 86F of the SCDA) may be paid by an "approved issuer" (as defined in s 86F of the SCDA) for the interest credited to that account pursuant to ss 86F and 861 of the SCDA.

Section CC 7

d) No income arises under s CC 7 for BNZ or its customers in relation to the Arrangement.

Section BG 1

e) Section BG 1 does not apply to the Arrangement.

The period or income year for which this Ruling applies

This Ruling will apply for the period beginning on 1 April 2022 and ending on 31 March 2027.

This Ruling is signed by me on the 13th day of December 2022.

Scott Davidson

Tax Counsel

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.

TRU 22/01: Variation to s 59BA(2) of the Tax Administration Act 1994 for trustees of certain trusts that derive a small amount of income

Variation

The Commissioner of Inland Revenue has, under the discretion provided under section 59BA(5) of the Tax Administration Act 1994, made the following statutory variation:

1. Section 59BA(2)(a) – (e) of the Tax Administration Act 1994 is varied for a trustee of an Eligible Trust to the name, date of birth, jurisdiction of tax residence, and tax file number and taxpayer identification number, of each settlor who makes a settlement on the trust in the income year.
2. For the purpose of this variation, a trust is an Eligible Trust, for a tax year, where the trustee of the trust derives assessable income for the tax year, the trust is a complying trust under section HC 10 of the Income Tax Act 2007, and the trust satisfies Criteria A and/or Criteria B.

Criteria A:

3. For the corresponding income year for a tax year, the trustee of the trust:
   - has derived no income other than income that would be reportable income, as defined in section 22D of the Tax Administration Act 1994, if the trust was an individual, to the extent to which the total amount of that income does not exceed $1,000; and
   - has no deductions; and
   - has not been a party to, or perpetuated, or continued with, transactions with assets of the trust which, during the corresponding income year:
     - give rise to income in any person's hands; or
     - give rise to fringe benefits to an employee or to a former employee.
4. In determining whether a trust complies with the requirements of Criteria A, no account shall be taken of any:
   - reasonable fees paid to professional persons to administer the trust; or
   - bank charges or other minimal administration costs totalling not more than $1,000 in the income year; or
   - insurance, rates, interest, and other expenditure incidental to the occupation of a dwelling owned by the trust and incurred by the beneficiaries of the trust.

Criteria B:

5. For the corresponding income year for a tax year:
   - the trust is a testamentary trust; and
   - distributions from the trust during the income year do not exceed $100,000; and
   - where the trust earned income that would be reportable income, as defined in section 22D of the Tax Administration Act 1994, if the trust was an individual, tax has been deducted from that income at the correct rate, and the total amount of that income does not exceed $5,000 for the income year; and
   - the trust derives non-reportable income of $1,000 or less and the trust has deductions against that income of at least $800 for the income year.

Application date

This variation applies for the 2021-22 income year and, for a trustee of a trust that is wound up during the 2022-23 income year, the 2022-23 income year.

Dated at Wellington on 18 November 2022.

Catherine Atkins

Deputy Commissioner, Customer and Compliance Services – Business

Inland Revenue

Background (material under this heading does not form part of the variation)

Summary of effect

1. Under s 59BA(1) of the Tax Administration Act 1994 (TAA) a trustee of a trust who derives assessable income for a tax year must file a return of all income derived in the corresponding income year (unless the trustee has been excused from filing a return under s 43B of the TAA). Section 59BA(2) of the TAA sets out further information a trustee is required to provide to the Commissioner of Inland Revenue (the Commissioner).
2. The variation limits the information that a trustee of an Eligible Trust is required to disclose to comply with s 59BA(2) of the TAA and means that a trustee of an Eligible Trust does not need to provide all the information set out in s 59BA(2)(a) – (e) of the TAA.
3. The Inland Revenue Department website will set out how a trustee applying the variation is to provide the information.
4. The variation will apply for the 2021-22 income year and, for a trustee of a trust that is wound up during the 2022-23 income year, the 2022-23 income year.
5. Section 43B of the TAA allows a trustee of a "non-active" trust to be excused from the requirement to file a return where certain criteria are met. A trustee of a trust that is excused from the requirement to file a return by s 43B of the TAA is not required to comply with the disclosure requirements in s 59BA(2).
6. Amendments proposed in the Taxation (Annual Rates, for 2022-23, Platform Economy and Remedial Matters) Bill (No 2) (the Bill), which was introduced on 8 September 2022, would broaden s 43B of the TAA, so that trustees of more trusts (including certain testamentary trusts) that derive small amounts of income would qualify for an exclusion from filing a return. These amendments are proposed to have effect from the 2021-22 income year.
7. The criteria to determine which trustees would qualify for the more limited disclosure requirements in this variation are consistent with what the criteria in s 43B of the TAA would be provided the amendments proposed in the Bill are enacted into law. However, unlike s 43B of the TAA, the variation does not provide an exclusion from filing a return (i.e. a trustee of an Eligible Trust would still be required to file a return under s 59BA(1) of the TAA).

Provisions affected

8. Section 59BA(2) of the TAA.

Application of variation

9. This variation applies to a trustee of an Eligible Trust that is subject to the information disclosure requirements in s 59BA(2) of the TAA. It varies the information that a trustee of an Eligible Trust needs to provide to the Commissioner to comply with s 59BA(2) of the TAA.
10. A trustee of an Eligible Trust can also choose to provide all the information required by s 59BA(2)(a) – (e) of the TAA.

References

Legislative references

Tax Administration Act 1994: ss 59BA(2) and 59BA(5).

REVENUE ALERTS

Provides information about a significant and/or emerging tax planning issue that is of concern to Inland Revenue.

RA 22/01: Consequences of acquiring, possessing or using electronic sales suppression tools

Inland Revenue is aware of the existence of Electronic Sales Suppression tools (ESS tools) which are used to systematically alter point-of-sale data collected by a business in order to understate or completely conceal revenues for the purpose of evading tax.

The Commissioner considers that the threat that such tools pose to the integrity of the tax system is significant. Therefore, a number of measures were introduced in 2022 to respond to the threat posed by the ESS tools, including new civil and criminal penalties. The Commissioner is increasing the compliance focus to more closely monitor the use of ESS tools and will consider all of the options that are available to him whenever these ESS tools are found.

The purpose of this Revenue Alert is to highlight the possible consequences of being involved with ESS tools.

All references are to the Tax Administration Act 1994 unless otherwise specified.

Background

1. A number of new measures have been introduced to respond to the threat posed by ESS tools to discourage their spread within the New Zealand tax base.
2. ESS tools are software programs, devices, or other tools that systematically alter point-of-sale data collected by a business. The software provides a means to understate or completely conceal revenues, which facilitates tax evasion. These tools can work in a variety of ways, targeting the integrity of transactions, software, internal memory, external filing, or reporting to delete, change, or simply not record select sales data and transactions.
3. Manipulation occurs either at, or after, the point of sale. These tools have varied functionalities but may be able to:
    - Permanently delete and re-sequence transactions.
    - Change transactions to reduce the amount of a sale.
    - Misrepresent records (for example, re-categorising a product to avoid GST).
    - roduce false records.
4. The term "electronic sales suppression tool" is defined in section 3 of the Tax Administration Act 1994 as meaning:

A software program, device, tool, or other thing, part of a thing, or combination of things or parts,—

(a) that can hide, conceal, modify, falsify, destroy, or prevent the creation of a record that—

(i) a person is required under a tax law to make or keep; and

(ii) is, or would be, created by a system that is or includes an electronic point of sale system; and

(b) the use of which would lead to a reasonable conclusion that 1 of its principal functions is to facilitate the concealment, modification, falsification, destruction, or prevention of the creation of a record.

5. A new civil penalty and two new criminal offences have been introduced in relation to involvement with ESS tools:
    - New section 141EE establishes the ESS penalty of $5,000 for the acquisition or possession of a suppression tool.
    - New section 143BB establishes an offence of manufacturing or supplying a suppression tool. A person convicted of such an offence is liable to a fine of up to $250,000.
    - New section 143BC establishes an offence of acquiring or possessing a suppression tool. A person convicted of such an offence is liable to a fine of up to $50,000.

Current view

6. The Commissioner considers the threat that ESS tools pose to the integrity of the tax system is significant.
7. Therefore, the Commissioner will be increasing his focus on identifying the customers who are or may be thinking of acquiring, creating or using the ESS tools. Where cases are disclosed, the Commissioner will be considering all of the options that are available to him to respond whenever these tools are found.

Offence of manufacturing or supplying suppression tools (section 143BB)

8. It is an offence under143BB(1) to:
   - Manufacture, develop, or publish a suppression tool that is provided to a person:
     i) who is liable for an ESS penalty,
     ii) who commits an offence under section 143BC,
     iii) or who commits an offence under section 143BB(2).
9. It is an offence under143BB(2) to:
   - Knowingly supply, make available for use, or otherwise provide a suppression tool, or the right to use a suppression tool, to a person resident in New Zealand, or knowingly provide a service to a person resident in New Zealand that includes the use of a suppression tool (subsection (2)).
10. The penalty for committing any of these offences is a fine up to a maximum of $250,000.
11. If you are considering involvement in some way in creating or providing ESS tools you should be aware Inland Revenue will be actively considering prosecution under section 143BB in appropriate cases.

Acquiring or possessing electronic sales suppression tools

Electronic sales suppression penalty (section 141EE)

12. Section 141EE of the TAA establishes a civil penalty for taxpayers who knowingly acquire, possess or control a suppression tool, or have the right to use the suppression tool, with the purpose of evading their own, or some other person's, assessment or payment of tax (referred to as the ESS penalty).
13. It is important to note that a person is treated as meeting the purpose test if they have used the suppression tool to evade the assessment or payment of tax.
14. An exception to the penalty exists for taxpayers who acquire a business whose operations include the use of a suppression tool if the taxpayer could not reasonably have known of the tool's existence and has not used the tool. This ensures taxpayers who accidentally acquire a tool in this way are not penalised for this unintentional acquisition.
15. The ESS penalty amount is set at $5,000.

Offence of acquiring or possessing suppression tools (section 143BC)

16. Section 143BC of the TAA establishes the criminal equivalent of the civil ESS penalty. It provides that it is an offence for a taxpayer required to keep records under a tax law to knowingly acquire, possess or control a suppression tool, or have a right to use the suppression tool, with the purpose of evading their own or some other person's assessment or payment of tax.
17. The penalty for committing this offence is a fine of up to a maximum of $50,000.
18. If you are considering getting ESS tools you should be aware that Inland Revenue will be actively considering prosecution under section 143BC in appropriate cases.

Further consequences of using electronic sales suppression tools

19. As well as the new civil and criminal penalties further consequences could arise for taxpayers who use ESS tools.
20. Firstly, the Commissioner considers that the use of sales suppression tools to reduce sales with a resulting decrease in the income tax and/or GST that might otherwise arise is tax evasion.
21. Where ESS tools are used the Commissioner will consider whether to prosecute in relation to the tax evasion (for example under section 143B). A person who is convicted of an offence under that section is liable to:

    (a) imprisonment for a term not exceeding 5 years; or

    (b) a fine not exceeding $50,000; or

    (c) both.

22. This is in addition to any prosecution for acquiring or having possession or control of an electronic sales suppression tool or a right to use a suppression tool.
23. Importantly, taxpayers who use these tools to artificially decrease tax liabilities may also be subject to the shortfall penalty that applies for evasion or similar act. The penalty is 150% of the resulting tax shortfall.
24. This is in addition to being required to pay the actual tax shortfall that arises from using the ESS tools as well as any resulting use of money interest and late payment penalties.

Reduction in penalty for previous behaviour not available

25. Further, the reduction in a shortfall penalty for previous behaviour is not available in relation to the 150% shortfall penalty where ESS tools have been used.

Write-off

26. It is important to note that the Commissioner cannot write off amounts owing (including the shortfall penalty imposed) when a taxpayer is liable to pay a shortfall penalty for an abusive tax position or evasion or a similar act, in relation to the outstanding tax.
27. This means that where ESS tools have been used to evade tax, the outstanding amount tax plus any penalties and interest that will also arise cannot be written off. The options left to the Commissioner when the outstanding tax cannot be paid (even by instalment) are bankruptcy or liquidation.

Time-bar

28. There are time limits in place for both GST and Income Tax which generally prevent the Commissioner from increasing assessments after the expiry of the applicable four-year period (this restriction is commonly referred to as the time-bar). Due to the nature of the activity if ESS tools are used to artificially reduce tax liability this restriction does not apply.

Current status

29. Inland Revenue is currently investigating the extent to which ESS tools are present in New Zealand.
30. Where we identify specific instances of ESS tools being used to evade tax, Inland Revenue will consider all of the options available to the Commissioner to respond to the presence of those tools. This will include consideration of the imposition civil penalties and the possibility of prosecution.
31. The Commissioner will require payment of any evaded tax, plus penalties and use of money interest. Where payment is not made, the Commissioner will consider applying for the taxpayer to be put into bankruptcy or liquidation.
32. If you consider that you may have become involved with ESS tools, we recommend you discuss the matter with your tax advisor, or with us and consider making a voluntary disclosure.
33. Guidelines for making a voluntary disclosure are contained in Standard Practice Statement SPS 19/02 and on the Inland Revenue website.

Authorised by

Tony Morris,

Customer Segment Leader

Legislative References

Ss 141EE, 143B, 143BB, 143BC of the Tax Administration Act 1994.

QUESTIONS WE'VE BEEN ASKED

This section of the *TIB* sets out the answers to some day-to-day questions people have asked. They are published here as they may be of general interest to readers.

QB 22/10: Can a close company deduct interest on a shareholder loan account where the amount is not known until after balance date?

Question

Can a close company deduct interest on a shareholder loan account in its tax return if the exact amount of interest is not known until after balance date?

Answer

Yes – a close company can do so if it has a legal obligation to pay the interest on the shareholder loan account based on a previously agreed formula or method. The company must have the legal obligation, including a method of calculating the liability, before its balance date, which is usually 31 March. The financial arrangements rules (FA rules) may apply to determine the timing of the deduction.

Companies need to keep records of the method they used to determine the amount of interest owing and of the legal obligation to pay the interest.

Key terms

Close company means a company with 5 or fewer natural persons or trustees who hold more than 50% of the voting interests or market value interests in the company. All natural persons associated at the time are treated as one person (s YA 1 and s YB 3). Close companies are often small businesses owned and operated by family members.

FA rules means the rules in subpart EW that require parties to a financial arrangement to spread income or expenditure from the arrangement over its term. The key purpose of the FA rules is to prevent deductions for expenditure being accelerated and income recognition being deferred.

Explanation

1. ***Public Information Bulletin*** No. 130 on "Deductibility of interest, the quantum of which has not been determined at balance date" (September 1984:7) (**the PIB**)[1] discussed post-balance date adjustments by a company for interest on shareholders' loan accounts. The PIB stated that such adjustments must be subject to a contractual obligation showing how to calculate the interest to be paid or credited to the shareholder. This QWBA updates the PIB to reflect changes in case law on when expenditure is incurred. It also sets out the resident withholding tax consequences of interest payments made to shareholder loan accounts.

Background

2. Most close companies are automatically allowed a deduction for interest incurred on a loan although some interest is not deductible (s DB 7). However, not all companies get an automatic deduction. Qualifying companies, some non-resident companies and companies that derive exempt income (except in certain circumstances) are some of the excluded companies.
3. Usually a company knows how much interest it owes on any money it has borrowed and how much it can deduct as an expense. However, where a company borrows money from its shareholders, it may not be able to calculate the amount of interest payable until after its balance date.

[1] This item is set out in full at the end of this document.

4. This is often the case for close companies who have only a few shareholders. Amounts owing to shareholders such as interest or a salary may be credited to a shareholder's loan account, but the amount owing may depend on the company's profitability. Such amounts may not therefore be determined until after balance date. For example, a company has an extended period in which to pay shareholder-employees their salary (s EA 4(3)). Once the company has determined its result for the year and calculated the shareholder-employees' salaries, it will know the final balance of those shareholders' loan accounts and can calculate any interest owing to shareholders.
5. Interest is normally paid on shareholder loan accounts at a market rate. If interest is paid at above market rates, it may give rise to FBT or a non-cash dividend.[2]
6. To deduct interest at balance date, where the exact amount owing is not known until after that date, a company must show that:
   - it has incurred the interest on or before balance date, and
   - the amount is calculated based on a previously agreed formula or method.
7. A shareholder loan account is a loan between a company and a shareholder. Loans are generally subject to the FA rules. The FA rules will therefore determine when interest income from a loan is derived and when a deduction for the interest payment can be taken. Under the FA rules, shareholders that are associated with a company, for example, through family or trust relationships, may have to account for interest on the same basis as the company (s EW 59). This will usually be on an accrual basis.

Incurring interest

8. Interest is deductible in the year in which it is incurred, unless other tax laws, such as the FA rules, apply (s BD 4(2)).[3] A company incurs interest when it pays, agrees to pay or becomes definitively committed to the interest.[4] This means that a company must have an existing legal obligation to pay the interest. A legal obligation can exist even if the obligation to pay the interest has a condition attached or the obligation can be changed.[5] For example, a company would still have a legal obligation to pay interest if the company and its shareholders agreed that interest would only be paid on the shareholders' loan accounts if the company made a profit.
9. If there is just a possibility that interest might be payable, the company will have no legal obligation to pay it. This situation might occur where directors have discussed the payment of interest and agreed to see if the company has made enough profit before deciding whether interest should be paid. In that case, the company has no legal obligation to pay on or before balance date.
10. For close companies (like other companies), the obligation to manage the business and affairs of the company rests with the board of directors.[6] Therefore, whether a close company has an existing legal obligation to pay interest on a shareholder loan account should be reflected in a decision of the directors of the close company (who may also be shareholders of the company)[7].
11. For example, there may be written agreements, meeting minutes, director resolutions, correspondence with shareholders or other written confirmation that the company agrees to pay interest on shareholders' loan accounts. The legal obligation must be to pay interest, not just to repay the loan.

[2] See "IS 21/10 Non-cash dividends" (2 July 2021) *Tax Information Bulletin* Vol 33 No 7 (August 2021): 16.

[3] For more detail on financial arrangements, see "IS 22/05: Cash basis persons under the financial arrangements rules", *Tax Information Bulletin* Vol 34, No 8 (September 2022): 38, or "IS 20/07: Income tax – Application of the financial arrangements rules to foreign currency loans used to finance foreign residential rental property", *Tax Information Bulletin* Vol 32, No 7 (August 2020): 110.

[4] *CIR v Mitsubishi Motors New Zealand Ltd* (1995) 17 NZTC 12,351.

[5] *FCT v James Flood Pty Ltd* (1953) 88 CLR 492.

[6] Section 128 of the Companies Act 1993.

[7] *A M Bisley & Co Ltd & Ors v CIR* (1985) 7 NZTC 5,082.

Example 1: Interest has not been incurred

Upkwick NZ Limited has three shareholders who are also directors – Miley, Miriana and Taylor. Each shareholder has a shareholder's loan account. The company is newly incorporated and unsure whether it will make a profit in its first year of operation (to 31 March 2022) as a housebuilder. In July 2022, the accountant confirms that the company has made a small profit. The directors did not discuss whether interest would be paid on any shareholders' loan accounts until their accountant contacted them to ask whether interest was to be paid. In August 2022, the directors agreed at a company meeting that interest should be charged on the balances of the shareholders' loan accounts at the end of every income year as long as the company makes a sufficient profit. The company agrees that the rate of interest should be the same rate as the 1-year fixed term deposit rate at Milton Bank on 31 March each year. On the same day, Miriana emails the company accountant to relay the company's decision. The accountant includes this in the August 2022 company minutes.

Upkwick NZ Limited has not incurred any interest in its first year of operation. The directors did not determine whether any interest was to be charged on the shareholder loan accounts until after the end of the income year. The interest is therefore not deductible in the income year ended 31 March 2022.

Example 2: Interest has not been incurred

Snazzy Sox Limited has two shareholders who are also directors – Aroha and her grandfather Hemi. In setting up the company in May 2021, Hemi provided 95% of the funding required to manufacture merino socks for dogs. Before 31 March 2022, the directors discuss whether the company should pay interest on Hemi's shareholder loan account. Hemi tells Aroha that there's no need for the company to pay him interest for the first couple of years, but that he might need some interest to be paid on the loan in 2024, depending on the company's financial situation, because his grandson Etera is getting married in that year. The directors agree that the company will discuss paying interest on any shareholder loan accounts in 2023.

Snazzy Sox Limited has not incurred a legal obligation to pay Hemi interest in any of the 2022-24 income years, as any payments are no more than pending, threatened or expected in those years.

Example 3: Interest has been incurred

Spurred on by its success in 2022, Upkwick NZ Limited from Example 1 continues to build houses in the 2023 income year. In July 2023, the company's accountant confirms that the company has made a sufficient profit to pay interest on the shareholder loan accounts. The accountant determines the interest payable on each shareholder loan account based on the company minutes from August 2022 which show the company's agreement to pay interest and how to calculate the interest payable.

Because the company agreed to charge interest before 31 March 2023, identified a method of calculation and emailed the company's accountant with this information, Upkwick NZ Limited can demonstrate that it has a legal obligation to pay interest to its shareholders on their loan accounts in the income year. Upkwick NZ Limited has therefore incurred interest in the income year ending 31 March 2023.

Method of determining the amount payable

12. Part of having a legal obligation to pay interest is being able to work out how much interest is owed. With shareholder loan accounts, this calculation may not be possible until after balance date.

13. However, if before balance date a company and its shareholders have agreed how to calculate the amount of interest that will be payable once the company's accounts are finalised, the company can deduct the interest in its tax return.[8] The method of calculation must be agreed in the year for which the deduction is sought, that is, before balance date. There must be a method of calculation and it must be certain. Guessing how much interest should be paid is not a method of calculation.

[8] *RACV Insurance Pty Ltd v FCT* 74 ATC 4169; *Commercial Union Assurance Company of Australia Ltd v FC of T* 77 ATC 4186.

14. Methods of calculating the amount of interest payable could be based on:
    - the terms of an agreement that provides a method of calculating the interest,
    - a bank rate at a given date, or
    - interest rates used in previous years.
15. A company must keep documents to show the method it has agreed to use to calculate the interest. These could include written agreements, meeting minutes, directors' resolutions, correspondence with shareholders or other written confirmation as to how the amount is calculated.

Example 4: Method of calculation is certain

The Closet Company Limited has a business offering home storage solutions. Its five shareholders are all family members. Two of the shareholders are also directors. When the company was first established in July 2021, the directors discussed the payment of interest on shareholder loan accounts at a board meeting. They agreed that an interest rate of 1% more than the interest rate on balance date, on a 1-year fixed term deposit at Milton Bank, will be applied to the balance of the individual shareholder loan accounts at balance date. This decision is recorded in the minutes kept by the Closet Company Limited.

The Closet Company Limited has incurred an interest expense in the income year. The amount of interest payable can be calculated using the current Milton Bank interest rate at balance date. The company can also rely on the board meeting minutes to demonstrate its obligation to make payment and the method it used to calculate the interest amount.

Paying the interest

16. When a company pays interest owing to a shareholder, it may have to deduct resident withholding tax (RWT) from the payment and pay that amount to Inland Revenue. Generally, this requirement will apply if the company is resident in New Zealand and carrying on a taxable activity or is a non-resident carrying on a taxable activity in New Zealand through a fixed establishment (ss RE 3 and RE 4). However, the company may not be required to deduct RWT if it pays less than $5,000 in interest in the year (s RE 10).
17. For RWT purposes, a company will pay interest to a person when it:
    - gives the interest to them, for example, by bank transfer,
    - credits the amount to a shareholder's loan account, or
    - deals with the amount in their interest, or on their behalf, in some other way such as when it pays a bill to a third party for them (s YA 1 – definition of "pay").
18. The way that a company pays interest to shareholders determines whether payment has been made for RWT purposes. A company may pay interest to a shareholder for RWT purposes before transferring the funds to a bank account or crediting it to a shareholder's loan account. This situation could occur when directors make an unconditional resolution to pay the interest, or they approve the financial statements as shown in ***Example* 5**.
19. A company with non-resident shareholders may have to deduct non-resident withholding tax (NRWT) from a payment of interest. For more detail on when companies must deduct RWT and NRWT, see Resident withholding tax (RWT) and ***Resident withholding tax on interest (RWT) payer's guide*** IR 283 (June 2020), Non-resident withholding tax and ***NRWT Payer's guide*** IR 291 (September 2020).

Example 5: Payment of interest has been made

In late May 2023, the Closet Company Limited's accountant quantifies the interest due on the shareholder loan accounts and prepares the journal entries for the interest payments. The Closet Company Limited finalises its 2023 year-end accounts at an Annual General Meeting on 8 June 2023. The ratified accounts include the journal entries crediting the shareholder loan accounts of three of the shareholders with the interest payable. On 15 June 2023, the Closet Company Limited pays the other two shareholders their interest by bank transfer as requested.

The date of payment for RWT purposes for three of the shareholders is 8 June 2023 as this is the date that the directors of the Closet Company Limited ratified the accounts crediting the interest to the shareholder loan accounts. The date of payment for the other two shareholders is 15 June 2023, when the bank transfers were made. The Closet Company Limited should deduct RWT from the interest it pays to all its shareholders on these dates and return it to Inland Revenue by 20 July 2023.

Taking the deduction

20. Under the FA rules, parties to a financial arrangement must spread interest over the period of the arrangement. Where interest is accrued on shareholder loan accounts on a daily basis and paid on an annual basis, there will be no income or expenditure to spread. This means deductions can be taken when the company incurs the interest expense, and the interest income will need to be returned by the shareholders when they derive it.
21. If interest is not paid annually, Inland Revenue expects companies to apply the FA rules to determine when a deduction for the interest expense can be taken.

Receiving the interest

22. A shareholder will be treated as receiving interest in the year that they derive it. Which year this is will depend on whether the shareholder returns their income as they receive it or as they earn it (even if they haven't received payment) (s BD 3(3)). If the FA rules apply to spread any income, those rules will determine the time of derivation.
23. As noted at [7], under the FA rules, shareholders that are associated with a company may have to account for interest on the same basis as the company (s EW 59). A company and a shareholder (who is not a company) will be associated persons if the shareholder has a voting interest in the company of 25% or more. However, if a shareholder is an associated person of another shareholder, their interests are combined and treated as one interest. With close companies usually being family-owned companies, shareholders are very likely to be associated with one another because they are related by blood, by family trust relationships or other relationships (ss YB 4 – YB 14). This means that both the company and its shareholders will have to account for interest on the same basis. This will usually be on an accrual basis.
24. A shareholder will still derive interest income if they do not receive it but the amount is credited to their account or they direct the company to use the money in another way for the shareholder's benefit (s BD 3(4)). For example, the shareholder may direct the company to pay the interest amount directly to satisfy the shareholder's debt with a third party.
25. A shareholder can claim a credit for any RWT deducted and paid in their tax return for the year that they derive the interest.

Example 6: Use of RWT credit

The Closet Company Limited in Example 5 pays interest to its shareholders on 8 June and 15 June 2023. It also deducts an amount of RWT on these dates. On 18 July 2023, the company's accountant reports the required information to Inland Revenue. This includes the interest paid, the RWT deducted and the names, contact details, IRD numbers and tax rates of the shareholders. At the same time, the accountant pays the RWT deducted to Inland Revenue.

The next day, the accountant prepares and files tax returns for the year ending 31 March 2023 for both the company and the shareholders. The company returns its income on an accrual basis. The shareholder loan accounts are financial arrangements and the company and the shareholders are associated persons. The accountant therefore returns the interest income of the shareholders on the same basis as the company and includes the interest income in the shareholders' tax returns for 31 March 2023. The shareholders' tax returns include a tax credit for the RWT deducted.

The shareholders can claim the amount of RWT withheld by the Closet Company Limited in their tax returns for the year ending 31 March 2023 because the RWT has been deducted and paid to Inland Revenue.

References

Legislative References

Income Tax Act 2007 – ss BD 3, BD 4, DB 7, EA 4, RE 3, RE 4, RE 10, YA 1, YB 1, YB 3 – YB 14 and subpart EW

Case References

A M Bisley & Co Ltd & Ors v CIR (1985) 7 NZTC 5,082

C of IR v Mitsubishi Motors New Zealand Ltd (1995) 17 NZTC 12,351

Commercial Union Assurance Company of Australia Ltd v FC of T 77 ATC 4186

FC of T v James Flood Pty Ltd (1953) 88 CLR 492

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Other References

"***Deductibility of interest, the quantum of which has not been determined at balance date", Public Information Bulletin, Vol 130*** (September 1984): 7.

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The PIB item

Deductibility of Interest, the Quantum of which has not been Determined at Balance Date

The Department is concerned at transactions of a retrospective nature. The area of concern is the practice of creating and claiming deductions for interest for which no liability existed at balance date. A typical example is the post-balance date adjustments by a company for interest on the shareholders' advances. Unless there is a contractual obligation at balance date to pay the interest it is the Department's view that the interest has not been incurred in the relevant income year. This view is well supported by case law.

While the actual quantum of the interest need not be determined by balance date, the interest adjustments must be subject to a contractual obligation (resolution or separate agreement) which shows how the interest to be paid or credited is to be calculated. The rate of interest payable, (e.g., 11 percent) need not necessarily be specified but some basis or measure for calculation would be expected, e.g., the average bank overdraft rate for the period. It is acknowledged that there will be circumstances, e.g., insufficient profits, where a lesser amount will actually be paid or credited and this generally will be acceptable.

In essence it is necessary that a contractual obligation, evidenced in writing, exists in the year of claim.

Where rates and amounts are not specified, or are subject to modification in certain circumstances, the method of determining the amount and/or the relevant circumstances, should be given.

TECHNICAL DECISION SUMMARIES

Technical decision summaries (TDS) are summaries of technical decisions made by the Tax Counsel Office. As this is a summary of the original technical decision, it may not contain all the facts or assumptions relevant to that decision. A TDS is made available for information only and is not advice, guidance or a "Commissioner's official opinion" (as defined in s 3(1) of the Tax Administration Act 1994). **You cannot rely on this document as setting out the Commissioner's position more generally or in relation to your own circumstances or tax affairs**. It is not binding and provides you with no protection (including from underpaid tax, penalty or interest).

TDS 22/20: GST – taxable activity

Technical decision summary - Adjudication

Decision date | Rā o te Whakatau: 10 August 2022

Issue date | Rā Tuku: 17 November 2022

Subjects | Kaupapa

GST: taxable activity.

Abbreviations | Whakapotonga

The abbreviations used in this document include:

CCS	Customer & Compliance Services, Inland Revenue
Commissioner or CIR	Commissioner of Inland Revenue
GST	Goods and services tax
GSTA	Goods and Services Tax Act 1985
TCO	Tax Counsel Office, Inland Revenue

Taxation laws | Ture tāke

All legislative references are to the Goods and Services Tax Act 1985 (**GSTA**) unless otherwise stated.

Facts | Meka

1. The Taxpayer is an individual who registered for GST because they were starting a new video production business. During the periods in dispute, the Taxpayer returned expenses relating to the cost of various electronic equipment and some accommodation costs and claimed input tax deductions, but did not return any income or output tax, resulting in a refund position.
2. Customer & Compliance Services, Inland Revenue (**CCS**) argued that the Taxpayer has not been carrying on a taxable activity. CCS considered any activity that was carried on by the Taxpayer was insufficiently continuous or regular to constitute a taxable activity and was merely commencement activity only, which does not itself amount to a taxable activity.

Issues | Take

3. The main issue considered in this dispute was whether the Taxpayer has been carrying on a taxable activity.
4. There was also a preliminary issue on the onus and standard of proof.

Decisions | Whakatau

5. The Tax Counsel Office (**TCO**) decided that the Taxpayer has taken steps towards establishing a taxable activity, but was not yet carrying on a taxable activity, having not yet moved beyond preparatory work.

Reasons for decisions | Pūnga o ngā whakatau

Preliminary issue | Take tōmua: Onus and standard of proof

6. The onus of proof in civil proceedings[1] is on the taxpayer, except for shortfall penalties for evasion or similar act, or obstruction.[2] The taxpayer must prove that an assessment is wrong, why it is wrong, and by how much it is wrong.[3]
7. The standard of proof in civil proceedings is the balance of probabilities.[4] This standard is met if it is proved that a matter is "more likely than not".[5] TCO applied a similar standard to considering the issue in this dispute, given the Taxpayer's ability to challenge any subsequent assessments that are made in civil proceedings.

Issue 1 | Take tuatahi: Taxable activity

8. The issue is whether the Taxpayer has been carrying on a taxable activity. If the Taxpayer has yet to commence a taxable activity, as CCS argued, the Taxpayer is not entitled to the input tax deductions claimed and the Commissioner can cancel the Taxpayer's registration from the date of registration.
9. Section 20 provides for the deduction of input tax from output tax, but only to the extent the goods or services to which the input tax relates are used for, or are available for use in, making taxable supplies.
10. "Taxable supply" is defined in s 2 to mean a supply of goods and services in New Zealand that is charged with tax under s 8. Section 8 imposes GST on supplies of goods and services made by a registered person in the course or furtherance of a taxable activity carried on by the registered person.[6] Therefore, to make taxable supplies, a person must be carrying on a taxable activity.
11. There are four requirements that must be satisfied to show there is a taxable activity under s 6(1)(a):
    - There must be an activity.[7]
    - The activity must be carried on continuously or regularly by a person.[8]
    - The activity must involve, or be intended to involve, the supply of goods and services to another person.[9]
    - The supply or intended supply must be made for a consideration.[10]
12. Section 6(2) provides that anything done in connection with the beginning or ending, including a premature ending, of a taxable activity is treated as being carried out in the course or furtherance of the taxable activity.

[1] Challenge proceedings (ie, the proceedings that would follow if this dispute proceeds to the Taxation Review Authority or a court) are civil proceedings.

[2] Section 149A(2) of the Tax Administration Act 1994 (TAA).

[3] *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271 (CA); *Beckham v CIR* (2008) 23 NZTC 22,066 (CA).

[4] Section 149A(1) of the TAA; *Yew v CIR* (1984) 6 NZTC 61,710 (CA); *Birkdale Service Station Ltd v CIR* (1999) 19 NZTC 15,493 (HC); *Case X16* (2005) 22 NZTC 12,216; Case Y3 (2007) 23 NZTC 13,028.

[5] *Miller v Minister of Pensions* [1947] 2 All ER 372, 374.

[6] See *Case N27* (1991) 13 NZTC 3,229 at 3,235.

[7] *Newman v CIR* (1994) 16 NZTC 11,229 (HC) at 11,233, *CIR v Bayly* (1998) 18 NZTC 14,073 (CA) at 14,078, and *Case 14/2016* [2016] NZTRA 14, (2016) 27 NZTC 3-036 at [63].

[8] *CIR v Newman* (1995) 17 NZTC 12,097 (CA) at 12,100; *Smith v Anderson* (1880) 15 Ch D 277 at 278; *Premier Automatic Ticket Issues Ltd v FCT* (1933) 50 CLR 268 (HCA) at 298; *Case 14/2016* at [67]-[68]; *Wakelin v CIR* (1997) 18 NZTC 13,182 (HC) at 13,185-13,186; *Case N27* (1991) 13 NZTC 3,229 at 3,238-3,239; *Allen Yacht Charters Ltd v CIR* (1994) 16 NZTC 11,270 (HC) at 11,274; *Case P20* (1992) 14 NZTC 4,136 at 4,147; *Tout & Anor v Cook* (1991) 13 NZTC 8,053 (HC).

[9] Definition of "supply" in s 5(1); *Databank Systems Ltd v CIR* (1987) 9 NZTC 6,213 (HC) at 6,223; *Pacific Trawling Ltd v Chief Executive of the Ministry of Fisheries* (2005) 22 NZTC 19,204 (HC); *Case S77* (1996) 17 NZTC 7,483; *Case L67* (1989) 11 NZTC 1,391; *Case N27* at 3,239-3,238; *Case 14/2016* at [69].

[10] Definition of "consideration" in s 2(1); *CIR v New Zealand Refining Co Ltd* (1997) 18 NZTC 13,187 (CA) at 13,193; *Director-General of Social Welfare v De Morgan* (1996) 17 NZTC 12,636 (HC); *Suzuki New Zealand Ltd v CIR* (2001) 20 NZTC 17,096 (CA) at [61]; *Taupo Ika Nui Body Corporate v CIR* (1997) 18 NZTC 13,147 (HC) at 13,150; *Chatham Islands Enterprise Trust v CIR* (1999) 19 NZTC 15,075 (CA) at [18] and [30]. *Trustee, Executors and Agency Company New Zealand Limited v CIR* (1997) 18 NZTC 13,076 (HC) at 13,086; *Turakina Maori Girls College Board of Trustees v CIR* (1993) 15 NZTC 10,032 (CA).

13. The case law on the relevance of a beginning of a taxable activity confirms that s 6(2) adds anything done in connection with the beginning of a taxable activity to the taxable activity but does not create one where one would otherwise not exist. Section 6(2) merely adds the commencement activity to the taxable activity. By itself, it cannot amount to a taxable activity.[11]
14. TCO concluded that the Taxpayer was not carrying on a taxable activity, and therefore, was not entitled to the input tax deductions claimed for these reasons:
    - The Taxpayer has undertaken activities that could constitute an activity for the purposes of the s 6 definition of "taxable activity". However, it was clear that the Taxpayer has not been carrying on a taxable activity during the periods in dispute. While the Taxpayer has taken steps to establish their video production business, they have yet to achieve that enterprise. The steps taken by the Taxpayer, which included the purchase of set up equipment and producing sample work to demonstrate their skills, were preparatory and had not yet gone beyond the development work for a taxable activity.
    - While s 6(2) deems the inclusion of commencement (and termination) activity into the course of a taxable activity, the Taxpayer has not yet established any taxable activity. The case law is clear that commencement work can only be added to such an activity, and by itself, cannot amount to a taxable activity.
    - In terms of the definition in s 6(1), the Taxpayer's preparatory work in itself was not an activity that involves, or intends to involve, the supply of goods and services to another person for a consideration. In any event, the activity of the Taxpayer has not commenced to the necessary degree to be either continuous or regular to comprise a taxable activity.
15. The Commissioner may cancel a person's GST registration if the Commissioner is satisfied that the person is not carrying on a taxable activity (s 52(5)). The cancellation may be retrospective to the date the person was GST registered if the Commissioner is satisfied that the person did not carry on any taxable activity from that date (s 52(5A)). As the Taxpayer was not carrying on a taxable activity, the Commissioner is entitled to cancel the Taxpayer's GST registration from the date of registration.

[11] *Case 14/2016* at [72] and [96]; *Case P73* (1992) 14 NZTC 4,489 at 4,493 to 4,494. See also *Case 7/2012* (2012) 25 NZTC 1-019 and *Case S56* (1996) 17 NZTC 7,361.

TDS 22/21: Whether subdivision was a profit-making undertaking or scheme and a taxable activity

Technical decision summary - Adjudication

Decision date | Rā o te Whakatau: 29 August 2022

Issue date | Rā Tuku: 17 November 2022

Subjects | Kaupapa

Income tax: subdivision; undertaking or scheme; acquired for purpose of disposal; residential land exclusion.

GST: taxable activity

Abbreviations | Whakapotonga

The abbreviations used in this document include:

CCS	Customer & Compliance Services, Inland Revenue
Commissioner or CIR	Commissioner of Inland Revenue
GST	Goods and services tax
GST Act	Goods and Services Tax Act 1985
ITA	Income Tax Act 2007
TAA	Tax Administration Act 1994
TRA	Taxation Review Authority
TCO	Tax Counsel Office, Inland Revenue

Taxation laws | Ture tāke

All legislative references are to Income Tax Act 2007 (**ITA**) unless specified otherwise.

Facts | Meka

1. This dispute involved a two-lot subdivision carried out at a property by the Taxpayer.
2. The Taxpayer is an individual. While outside of New Zealand, the Taxpayer purchased a property in New Zealand (**the Property**). The Taxpayer funded the purchase out of their own money.
3. The Taxpayer stated that they acquired the Property for the purpose of renovating and extending it to live in with their extended family. The Taxpayer's extended family moved into the existing dwelling at the Property upon settlement. The Taxpayer joined the family at the Property upon their return to New Zealand a few months later.
4. An architect was engaged to consider the extension of the existing dwelling. However, due to some serious issues with the existing dwelling, such as drainage and asbestos, it was suggested that the Taxpayer should subdivide the Property into two lots and construct a new dwelling on each lot.
5. Consequently, plans for the two new houses were drawn up and finance was obtained from the bank to fund the project. A resource consent application was submitted to the local council, which was subsequently approved and issued, to demolish the existing dwelling, to construct two new dwellings and to subdivide the land into two lots. Building consents were also issued in respect of both lots.

6. While the works were undertaken, the Taxpayer's extended family moved into a rental property. The Taxpayer was outside of New Zealand for a part of that time but lived in the rental property with the extended family while they were in New Zealand.
7. The Taxpayer asserted that they occupied the newly constructed family home at the Property for 8 months prior to the subdivision of the land.
8. The subdivision of the Property was completed after the code compliance certificate was issued for both dwellings. Two new titles were issued – one for the land on which the family home was constructed (**House A**) and the other for the land on which the second dwelling was constructed (**House B**).
9. The Taxpayer sold House B soon after the subdivision was completed and received proceeds from the sale.
10. The Taxpayer lived at House A for a further 5 years after selling House B.

Issues | Take

11. The main issues considered in this dispute were:
    - whether the Taxpayer entered into an undertaking or scheme at the Property for the dominant purpose of making a profit for s CB 3 to apply to the sale of House B;
    - whether the Taxpayer acquired the Property for a purpose or with an intention of disposing of it for s CB 6 to apply to the sale of House B;
    - whether the residential land exclusion in s CB 17(2) prevented s CB 12 from applying to the sale of House B; and
    - whether the supply of House B was subject to GST.
12. There was also a preliminary issue on the onus and standard of proof.

Decisions | Whakatau

13. The Tax Counsel Office (**TCO**) decided that:
    - The Taxpayer did not enter into the undertaking or scheme at the Property for the dominant purpose of making a profit. Therefore, the sale proceeds are not income for the Taxpayer under s CB 3.
    - The Taxpayer acquired the Property for the sole purpose and with the sole intention of creating a home for themself and their extended family. Therefore, the proceeds of sale of House B are not income for the Taxpayer under s CB 6.
    - The Taxpayer occupied the Property mainly as residential land prior to the subdivision. Therefore, the exclusion in s CB 17(2) applies to the Taxpayer and the sale proceeds are not income for the Taxpayer under s CB 12.
    - The Taxpayer did not carry on a "taxable activity", as defined in s 6 of the Goods and Services Tax Act 1985 (**GSTA**), in carrying out the development, construction and subdivision project at the Property. Therefore s 8(1) of the GSTA does not require the Taxpayer to charge GST on the supply of House B.

Reasons for decisions | Pūnga o ngā whakatau

Preliminary issue | Take tōmua: Onus and standard of proof

14. The onus of proof in civil proceedings[1] is on the taxpayer, except for shortfall penalties for evasion or similar act, or obstruction.[2] The taxpayer must prove that an assessment is wrong, why it is wrong, and by how much it is wrong.[3]
15. The standard of proof in civil proceedings is the balance of probabilities.[4] This standard is met if it is proved that a matter is "more likely than not".[5]

[1] Challenge proceedings (ie, the proceedings that would follow if this dispute proceeds to the Taxation Review Authority (TRA) or a court) are civil proceedings.

[2] Section 149A(2) of the Tax Administration Act 1994 (TAA).

[3] *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271 (CA); *Beckham v CIR* (2008) 23 NZTC 22,066 (CA).

[4] Section 149A(1) of the TAA; *Yew v CIR* (1984) 6 NZTC 61,710 (CA); *Birkdale Service Station Ltd v CIR* (1999) 19 NZTC 15,493 (HC); *Case X16* (2005) 22 NZTC 12,216; *Case Y3* (2007) 23 NZTC 13,028.

[5] *Miller v Minister of Pensions* [1947] 2 All ER 372, 374.

16. An assessment made by the Commissioner cannot be arbitrary. He must make the best judgment he can on the information in his possession as to the amount of taxable income and the amount of tax payable. In some cases, a taxpayer may be able to discharge the onus of proof by showing that the assessment is arbitrary or demonstrably unfair.[6]

Issue 1 | Take tuatahi: Section CB 3 – undertaking or scheme

17. Section CB 3 includes in a taxpayer's assessable income amounts derived from the carrying on or carrying out of an undertaking or scheme entered into for the purpose of making a profit.
18. The issue is whether s CB 3 applies to the sale of House B.
19. Customer & Compliance Services (**CCS**) argued that s CB 3 applies to the sale of House B because the Taxpayer carried on or carried out an undertaking or scheme (involving the demolition of the existing dwelling, subdivision of the land into two lots, building a new dwelling on the land that became House B, and the sale of House B) entered into or devised for the dominant purpose of making a profit.
20. The Taxpayer argued that they carried on or carried out the development, subdivision and building work for the dominant purpose of providing a home for themself and their extended family.
21. The key principles derived from case law on s CB 3 are:
    - An undertaking or scheme is a programme of action, or series of steps, directed to an end result. The plan or purpose must be coherent and have some unity of conception, but it does not need to be precise. There must be a nexus between the undertaking or scheme and any gain derived.[7]
    - Not all schemes or undertakings come within the scope of s CB 3. In the case of an undertaking or scheme involving a single transaction of acquisition and re-sale, at least, the provision is intended to apply if the undertaking or scheme exhibits the characteristics of a business deal but falls short of a business.[8] The provision does not apply to tax capital gains where the taxpayer has done no more than realise a capital asset (even if this is done in a way that secures the best price).[9]
    - For s CB 3 to apply, profit-making must be the dominant purpose of entering into or devising the undertaking or scheme. A taxpayer may have more than one purpose for entering into or devising an undertaking or scheme; but for s CB 3 to apply, the purpose of making a profit must be "*the* purpose" for entering into or devising the undertaking or scheme.[10]
    - The focus is on the taxpayer's subjective purpose in entering into or devising the undertaking or scheme; but this is assessed objectively.[11] This is tested when the undertaking or scheme commences[12], this being when it is clear that the taxpayer has taken an overt step in putting into action a coherent plan formulated earlier.[13] This is to be determined on the facts of each case.[14]
    - In respect of an undivided block of land, it is the taxpayer's dominant purpose in relation to the block as a whole that is relevant.[15]

[6] *Lowe v CIR* (1981) 5 NZTC 61,006 (CA); *CIR v Canterbury Frozen Meat Co Ltd* (1994) 16 NZTC 11,150 (CA); *CIR v New Zealand Wool Board* (1999) 19 NZTC 15,476 (CA).

[7] *Investment & Merchant Finance v FCT* (1970) CLR 177 (HCA) at 189; *Vuleta v CIR* [1962] NZLR 325 (NZSC) at 329; *Duff v CIR* (1982) 5 NZTC 61,131 (CA) at 61,141; *Case S86* (1996) 17 NZTC 7,538 at 7,548.

[8] *McClelland v FCT* 70 ATC 4115 (PC) at 26-27; *Duff v CIR* (1982) 5 NZTC 61,131 (CA) at 61,141. The existence of a "business" is determined by applying the criteria in *Grieve v CIR* (1984) 6 NZTC 61,682 (CA).

[9] *Beetham v CIR* 72 ATC 6042 (NZSC) at 582-583; *Eunson v CIR* [1963] NZLR 278 (NZSC) at 281. See also *FCT v Whitfords Beach Pty Ltd* [1982] HCA 8, 82 ATC 4031 (HCA) at [9].

[10] *CIR v National Distributors Ltd* (1989) 11 NZTC 6,346 (CA) at 6,350. This contrasts with s CB 6, considered briefly later, where profit need only be **a** purpose (or intention) for acquiring the land.

[11] *CIR v National Distributors Ltd* at 6,351. See also *CIR v Walker* [1963] NZLR 339; (1962) 13 ATD 108 (HC)

[12] *Gilmour v CIR* [1968] NZLR 136 (NZSC); *Case S86* at 7,548

[13] *Cross & Anor v CIR* (1987) 9 NZTC 6,101 (CA) at 6,106 and 6,111-6,112.

[14] *Smith v CIR* (1987) 9 NZTC 6,118 (CA) at 6,125.

[15] *CIR v Walker* at 121, 123-124 and 128.

22. Based on the facts and the evidence presented in this dispute, TCO decided that the Taxpayer did not enter into the undertaking or scheme at the Property for the dominant purpose of making a profit, and therefore, the proceeds from the sale of House B were not income for the Taxpayer under s CB 3 for these reasons:
    - The Taxpayer entered into an undertaking or scheme in relation to the Property for the demolition of the existing dwelling and associated development work, the construction of two new dwellings, and subdivision of the Property into two lots. The undertaking or scheme commenced when the Taxpayer applied for a resource consent for the development, construction and division work.
    - Where an undertaking or scheme involves a single transaction of acquisition and re-sale, s CB 3 does require that the undertaking or scheme exhibits the characteristics of a "business deal" but does not require that a "business" is carried on in terms of the criteria in ***Grieve***. It is considered the Taxpayer's undertaking or scheme arguably did not involve "a single transaction of acquisition and re-sale". However, even if it did, the Taxpayer's undertaking or scheme did not exhibit the characteristics of a "business deal".
    - Where land is undivided (as the Property was when the Taxpayer entered into the undertaking or scheme), the relevant case law establishes that it is not possible for a taxpayer to have separate "dominant" purposes for separate parts of the undivided land. The Taxpayer's purpose for the sale of House B must be viewed in light of their purpose for the whole property on commencement of the undertaking or scheme. The Taxpayer's dominant purpose for the Property as a whole on entering into the undertaking or scheme was to create a new home for themself and their extended family.

Issue 2 | Take tuarua: Section CB 6 – acquired for purpose of disposal

23. Under s CB 6, an amount that a person derives from disposing of land is income of the person if they acquired the land:
    - for one or more purposes that included the purpose of disposing of it, and/or
    - with one or more intentions that included the intention of disposing of it.
24. TCO concluded that the findings that the Taxpayer acquired the Property for the sole purpose and with the sole intention of creating a new home for themself and their extended family, prevented any finding that s CB 6 applied to treat the sale proceeds of House B as income.

Issue 3 | Take tuatoru: Residential land exclusion

25. The issue is whether the exclusion for residential land contained in s CB 17(2) prevents s CB 12 from applying to the sale of House B.
26. Section CB 12(1) taxes as income certain amounts that a person derives from the disposal of land where there is an undertaking or scheme involving the development of land or the division of land into lots. However, s CB 12(1) does not apply if an exclusion referred to in s CB 12(2) applies, one of which is the exclusion for residential land in s CB 17.
27. The exclusion in s CB 17(2) applies if the land disposed of is a lot resulting from the division into two or more lots of a larger area of land not exceeding 4,500 square metres immediately before the division and the larger area of land was occupied by the taxpayer mainly as residential land.
28. CCS argued the exclusion in s CB 17(2) did not apply on the basis that the Taxpayer did not occupy the Property mainly as residential land at the relevant times.
29. The Taxpayer argued that the exclusion contained in s CB 17(2) applied on the basis that the Taxpayer and their family did occupy the Property mainly as residential land at the relevant times.
30. The following principles can be derived from case law[16] that relates to the exclusion:
    - A taxpayer whose activities in relation to that land are carried on for the purposes of residing on that land has occupied that land as residential land.[17]
    - The division of the land into lots does not take place until the stage when a separate title can be issued in respect of the lots in question.[18]

[16] TCO concluded that the intended scope and effect of the residential exclusion in s CB 17(2) is the same as when it was first enacted as s 88AA(3) of the LITA 1954. Case law on the predecessor sections is therefore considered authoritative in interpreting s CB 17(2).

[17] *Case C33* (1978) 3 NZTC 60,312, also cited as TRA *Case 6* (1978) 3 TRNZ 54 Lloyd Martin SM.

[18] *Wellington v C of IR* (1981) 5 TRNZ 51,154.

- It is not necessary for the land to have had a dwellinghouse erected on it prior to subdivision or even for it to have been used "in conjunction with a residence" (as grounds) prior to subdivision. It is enough if the land was intended to be used by a taxpayer to erect their own home and/or if the taxpayer intended that the land was to form part of the grounds for the taxpayer's residence, provided there had been some work done towards achieving that objective.[19]
- Lots of land that were used or intended to be used as the grounds for a taxpayer's dwellinghouse are within the definition of "residential land" that is occupied by that taxpayer.[20]
- For a taxpayer to occupy land "mainly" (previously "primarily and principally") as residential land their foremost or chief reason for that occupation must be to use that land for their own residential purposes (or for residential purposes for themself and members of their family living with them).[21]

31. It is implicit from the case law that it does not matter if the taxpayer is temporarily absent from the land or has another home during the period of ownership of the relevant property prior to subdivision.
32. In addressing the parties' arguments, TCO made the following observations about s CB 17(2):
    - Section CB 17(2) is a use-based test. The exclusion is based on the taxpayer's intended use for the land. The case law indicates that land intended for use as a residence, but which is temporarily used for other purposes, such as commercial or farm land, could potentially be "occupied mainly as residential land" provided the taxpayer is taking steps to turn it into residential land.
    - Section CB 17(2) is not a time-based test as there is no reference in the text of the provision to a period of ownership. This can be contrasted with other provisions in the ITA, such as s CB 16A(1), which specifically refers to a day-count criterion.
    - There is no requirement that the taxpayer must reside on the land for more than 50% of the time of ownership. The text of the provision does not refer to the taxpayer "residing" on the land (unlike the exclusion in s CB 17(1)) and does not refer to a "dwelling" (as s CB 16A does) or to a "dwellinghouse" (as s CB 16 does).
    - The adjective "residential" describes the noun "land". It is the land that must be "residential". The person must "occupy" the land as residential land. The word "occupy" does not imply permanence (but it does require something more than visiting a property that is occupied by someone else).
    - Section CB 17(2) does not require that the land was occupied as residential land "immediately before" the subdivision, only that the larger area of land was 4,500 square metres or less "immediately before" the land was divided.
33. Based on the facts and the evidence presented in this dispute, TCO decided that the residential land exclusion in s CB 17(2) applied and, therefore, the sale proceeds were not income for the Taxpayer under s CB 12 for these reasons:
    - The Taxpayer first occupied the Property mainly as residential land for themself and their extended family from the date of settlement. The Taxpayer continued to occupy the Property mainly as residential land until the subdivision was completed (the date new titles were issued).
    - The relevant case law indicates that land is "occupied mainly as residential land" if the taxpayer mainly intends to use the land as their home (or as one of their homes), provided they have actually done so prior to the subdivision or have taken steps to do so prior to the subdivision. "Mainly" in this context means primarily and principally (or chiefly or pre-eminently). It is directed at the taxpayer's *main intended purpose* for the land, not their main use.
    - Considering the above in light of the Taxpayer's facts, the Taxpayer bought the Property in their own name and with their own money. The Taxpayer's extended family moved into the Property upon settlement, and it was intended that the Taxpayer would live there with them. The Taxpayer lived at the Property while they dealt with the architect. Even though the Taxpayer was outside of New Zealand when the project commenced, the Taxpayer returned before the project was completed to live in the rental accommodation with their extended family and, presumably, to prepare to move into House A.

[19] *Case C33*.

[20] *Wellington v C of IR*.

[21] *Case C9* (1977) 3 NZTC 60,058. See in contrast *Case G76* (1985) 7 NZTC 1,348; *Case K21* (1988) 10 NZTC 218; *Case M102* (1990) 12 NZTC 2,634; *Case 5/2013* (2013) 26 NZTC 2,004, where the dwellinghouses in question were not "primarily and principally" occupied as personal residences of the taxpayers.

- It did not matter that there was no habitable dwelling at the Property for a period of time, as the Taxpayer's main intended purpose for the Property had not changed during that period, and steps were taken to construct a new home at the Property. Nor did it matter that the Taxpayer spent time overseas. Their extended family (and presumably some of their belongings) remained at the Property as long as there was a dwelling there. The Taxpayer was unable to live at the Property for the larger part of their absence from New Zealand anyway, and so would have had to live in alternative accommodation if they had stayed in New Zealand.
- The Taxpayer's absence from New Zealand at the actual date of subdivision was not material as, again, their extended family and presumably their belongings remained at House A while the Taxpayer was temporarily overseas. The fact that the Taxpayer's main intended purpose for the Property had not changed by the subdivision date was supported by their subsequent conduct, in that they lived at House A for a further 5 years before selling it.

Issue 4 | Take tuawhā: GST

34. The issue is whether the supply of House B was subject to GST.
35. CCS argued the Taxpayer carried on a taxable activity in carrying out the development, building work and subdivision of the Property. Therefore, the Taxpayer should have been registered for GST and returned GST on the supply of House B.
36. The Taxpayer argued that the development and building work and subdivision of the Property was not a taxable activity and, therefore, they were not required to register for GST or return GST on the supply of House B.
37. Section 8(1) of the GSTA imposes GST on taxable supplies of goods and services made by a registered person in the course or furtherance of a taxable activity carried on by the registered person. Establishing that there is a taxable activity is crucial to whether a person should be registered for GST and subject to the GSTA.
38. There are four requirements that must be satisfied to show there is a taxable activity under s 6(1)(a) of the GSTA:
    - There must be an activity.[22]
    - The activity must be carried on continuously or regularly by a person.
    - The activity must involve, or be intended to involve, the supply of goods and services to another person.[23]
    - The supply or intended supply must be made for a consideration.[24]
39. CCS and the Taxpayer agreed that the development, construction, and subdivision project amounted to "an activity" carried on by the Taxpayer, and that the activity did involve the supply of goods and services (House B) to another person for consideration. However, the Taxpayer argued that the activity was not carried on "continuously or regularly", and therefore that there was no "taxable activity" as defined.

"Continuously or regularly"

40. To "carry on" an activity means that a person must be pursuing a course of conduct habitually or be engaging in a series of acts. The focus is on the activity as a whole and not on the individual steps involved in the activity.[25]
41. An activity is carried on continuously if:
    - it is carried on over a period, in a sequence uninterrupted in time, or it is connected;[26]
    - it has not ceased in a permanent sense, and has not been interrupted in a significant way;[27]
    - it is not intermittent or occasional.[28]

[22] *Newman v CIR* (1994) 16 NZTC 11,229 (HC) at 11,233, *CIR v Bayly* (1998) 18 NZTC 14,073 (CA) at 14,078, and *Case 14/2016* [2016] NZTRA 14, (2016) 27 NZTC 3-036 at [63].

[23] Definition of "supply" in s 5(1); *Databank Systems Ltd v CIR* (1987) 9 NZTC 6,213 (HC) at 6,223; *Pacific Trawling Ltd v Chief Executive of the Ministry of Fisheries* (2005) 22 NZTC 19,204 (HC); *Case S77* (1996) 17 NZTC 7,483; *Case L67* (1989) 11 NZTC 1,391; *Case N27* at 3,239-3,238; *Case 14/2016* at [69].

[24] Definition of "consideration" in s 2(1); *CIR v New Zealand Refining Co Ltd* (1997) 18 NZTC 13,187 (CA) at 13,193; *Director-General of Social Welfare v De Morgan* (1996) 17 NZTC 12,636 (HC); *Suzuki New Zealand Ltd v CIR* (2001) 20 NZTC 17,096 (CA) at [61]; *Taupo Ika Nui Body Corporate v CIR* (1997) 18 NZTC 13,147 (HC) at 13,150; *Chatham Islands Enterprise Trust v CIR* (1999) 19 NZTC 15,075 (CA) at [18] and [30]. *Trustee, Executors and Agency Company New Zealand Limited v CIR* (1997) 18 NZTC 13,076 (HC) at 13,086; *Turakina Maori Girls College Board of Trustees v CIR* (1993) 15 NZTC 10,032 (CA).

[25] *CIR v Newman* (1995) 17 NZTC 12,097 (CA) at 12,100; *Smith v Anderson* (1880) 15 Ch D 277 at 278; *Premier Automatic Ticket Issues Ltd v FCT* (1933) 50 CLR 268 (HCA) at 298; *Case 14/2016* at [67].

[26] *Wakelin v CIR* (1997) 18 NZTC 13,182 (HC) at 13,185-13,186; *Case 14/2016* at [68].

[27] *Case N27* (1991) 13 NZTC 3,229 at 3,238-3,239.

[28] *Allen Yacht Charters Ltd v CIR* (1994) 16 NZTC 11,270 (HC) at 11,274.

42. An activity is carried on regularly if:[29]
    - it is carried on in accordance with a definite course, or a uniform principle of action or conduct;
    - there is a proper correspondence between the elements of the activity.
43. This means that an activity is carried on regularly if the elements of it recur at fairly fixed times, or at generally uniform intervals, so as to be of a habitual nature and character.[30]
44. Whether an activity is being carried on continuously or regularly is a matter of fact and degree.[31] An activity that is of a "one-off" nature, never to be repeated, is unlikely to qualify as an activity carried on either continuously or regularly.[32]
45. A number of cases have considered whether there was a continuous or regular activity in the context of subdivision activities. The key principles drawn from these cases are:
    - A subdivision that is part of a continuing pattern of subdivision work is likely to be a continuous and/or regular activity.[33]
    - A one-off subdivision is not likely to be a continuous or regular activity.[34]
    - An activity leading to only one supply should not normally be regarded as carried on continuously or regularly.[35]
    - A one-off subdivision that involves a significant amount of physical development or other work (such as a high-end residential development) may be a continuous activity.[36] But if the subdivision involves a relatively minor amount of development work, it is unlikely to be a continuous activity.[37]
    - The lack of any commercial flavour is not sufficient to prevent an activity from being carried on "continuously" if it is of a large enough scale.[38]
46. TCO concluded that the Taxpayer's activity was not carried on continuously or regularly and, therefore, the Taxpayer was not carrying on a taxable activity for these reasons:
    - The development, construction, subdivision and sale of a single residential property (i.e. a "single supply" development) is usually regarded as a "one-off" transaction and does not amount to an activity carried on "continuously", unless the project is a high-end residential development project. Provided there was nothing extraordinary about the project, it should be regarded as a "one-off" transaction and the steps taken by the Taxpayer should merely be regarded as components of the "one-off" transaction.
    - The Taxpayer's project involved only one supply and was not connected to any other project. There was nothing extraordinary about the project. The section contour was flat and did not require extensive earthworks. House B was a relatively standard residential house. The amount of financial investment was on par with a standard two-lot development, construction and subdivision project carried on at that location at the time.
47. As the Taxpayer's activity was not a "taxable activity", the supply of House B was not made by the Taxpayer "in the course or furtherance of a taxable activity" carried on by them. Therefore, s 8(1) of the GSTA did not require the Taxpayer to charge GST on the supply of House B.

[29] *Wakelin* at 13,185-13,186; *Case 14/2016* at [68].

[30] *Case N27* at 3,239.

[31] *Newman* (CA) at 12,101; *Case 14/2016* at [67].

[32] *Newman* (CA) at 12,104; *Tout & Anor v Cook* (1991) 13 NZTC 8,053 (HC); *Allen Yacht Charters* at 11,274; *Case 14/2016* at [68].

[33] *Wakelin* at 13,185-13,186.

[34] *Case 14/2016*; *Tout & Anor v Cook*; *Newman* (CA).

[35] *Wakelin*; *Tout*; *Newman* (CA).

[36] See for example *Case P10* (1992) 14 NZTC 4,066; *Case P76* (1992) 14 NZTC 4,512; *Wakelin*; *Case 7/2012* [2012] NZTRA 07, (2012) 25 NZTC 1-019.

[37] *Newman* (CA).

[38] *Case 7/2012*.

LEGAL DECISIONS – CASE SUMMARIES

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, 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.

CSUM 22/05: Supreme Court confirms Frucor's tax avoidance and finds shortfall penalties apply

Decision date: 30 September 2022

Case

Frucor Suntory New Zealand Limited v Commissioner of Inland Revenue [2022] NZSC 113

Legislative References

Income Tax Act 2004, ss BG 1 and GB 1.

Tax Administration Act 1994, ss 141B, 141D and 141FB.

Legal terms

Tax avoidance, shortfall penalties, unacceptable tax position, abusive tax position.

Summary

The Commissioner of Inland Revenue (Commissioner) disallowed interest deductions claimed by the predecessor of Frucor Suntory New Zealand Limited (Frucor) in respect of a tax-driven structured finance transaction it entered into in March 2003 involving associated companies and the Deutsche Bank.

The Commissioner contended that the funding arrangement was a tax avoidance arrangement in terms of s BG 1 of the Income Tax Act 2004 (ITA) and denied a portion of Frucor's claimed interest deductions in the 2006 and 2007 income tax years. The Commissioner also contended that Frucor took an unacceptable tax position and an abusive tax position such that shortfall penalties should be imposed.

Frucor challenged the assessments and was successful in the High Court, with that Court holding that the funding arrangement was not a tax avoidance arrangement. The Commissioner's assessments for 2006 and 2007 were thereby cancelled.

The Commissioner appealed and the Court of Appeal allowed the appeal, set aside the orders of the High Court, reinstated the Commissioner's assessments based on tax avoidance with regards to the disallowed deductions but held that shortfall penalties did not apply.

Frucor appealed the finding on tax avoidance and the Commissioner cross-appealed the finding that shortfall penalties did not apply.

The Supreme Court dismissed Frucor's appeal, finding there was tax avoidance and allowed the cross-appeal, finding shortfall penalties for taking an abusive tax position also applied.

Case Impact Statement

The decision of the Supreme Court confirms the legal framework for consideration of avoidance under s BG 1(1) of the ITA as articulated in ***Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue*** [2008] NZSC 115. The Court did not signal that it was making a change in approach from that of the ***Ben Nevis*** Court.

In line with the Supreme Court's summarised reasons for finding tax avoidance, the Commissioner considers that using a tax provision allowing deductibility where the economic cost or burden has not been suffered will usually be outside Parliament's contemplation. In other words, where there is no expenditure incurred in an economic sense, Parliament would not have contemplated a deduction unless the specific provisions indicate otherwise. Artificiality and contrivance will reinforce such a conclusion.

Similarly, where an income provision does not apply but the economic benefits are enjoyed by the taxpayer, this too will usually be outside Parliament's contemplation.

The Supreme Court decision confirmed the Commissioner's broad powers to counteract any tax advantage from an arrangement deemed void in accordance with s BG 1 of the ITA through application of s GB 1 of the ITA. The Court also noted that consideration of counterfactuals as part of the counteraction process is permitted, but not mandatory.

The Commissioner considers that the Supreme Court's judgment on shortfall penalties is also an orthodox one and it does not alter the approach to determining whether an abusive tax position (ATP) shortfall penalty should apply. Shortfall penalties do not follow automatically from a finding of tax avoidance, and their applicability is a separate enquiry.

The enquiry under s 141D of the TAA for an ATP penalty firstly involves whether a taxpayer took an unacceptable tax position because, viewed objectively, the tax position failed to meet the standard of being about as likely as not to be correct. The Supreme Court clarified that it is not appropriate to replace the statutory "about as likely as not to be correct" test with a test of substantiality, based on the language used in ***Ben Nevis***. Aside from this clarification, the Commissioner considers that the Supreme Court took an orthodox approach to determining whether a taxpayer has taken an unacceptable tax position.

If there is an unacceptable tax position, s 141D requires an ATP shortfall penalty if the arrangement was entered into with a dominant purpose of avoiding tax. In contrast, s BG 1 has a lower threshold, requiring an arrangement have a more than merely incidental purpose of avoiding tax.

The ATP penalty tests were considered satisfied on the facts as the Supreme Court found them to be, having also analysed the state of the law at the time the tax positions were taken. The Court considered the arrangement was based on a "generic tax-driven structure" developed by Deutsche Bank (which received a significant arranger fee) and the convertible note structure had no point, "leaving aside the purpose of obtaining tax advantages in New Zealand".

A discount of 50% under s 141FB of the TAA may apply in circumstances where the taxpayer has not previously had a penalty imposed.

Facts

Frucor entered into a funding arrangement, whereby Deutsche Bank advanced $204m to Frucor in exchange for a fee of $1.8m and a convertible note redeemable at maturity in five years' time by the issue of 1,025 non-voting shares in Frucor (the note).

The $204m advance by Deutsche Bank was funded by a contemporaneous payment of $149m from Frucor's parent, Danone Asia Pty Ltd (DAP), for the forward purchase of the shares from Deutsche Bank in five years' time at a pre-agreed price matching the face value of the note (the forward purchase agreement). The balance of $55m was contributed by Deutsche Bank.

Over the life of the note, Frucor paid $66m to Deutsche Bank and claimed the full $66m as interest payments on an interest only basis on $204m. The $66m coupon payments equated to the amount required to pay amortising principal and interest on the $55m introduced into the funding arrangement by Deutsche Bank.

Issues

The issues for consideration by the Supreme Court were:

- Whether s BG 1 of the ITA (the general anti-avoidance provision) was engaged?
- Whether the Commissioner's reconstruction under s GB 1(1) of the ITA, disallowing some of the interest deductions claimed, was correct? and
- Whether the tax positions adopted by Frucor were "unacceptable" on the basis that they did not meet the "about as likely as not to be correct" standard of s 141B of the TAA, and if so, whether they were also "abusive" on the basis that Frucor had acted with the "dominant purpose" of obtaining tax advantages (s 141D of the TAA).

Decision

Tax Avoidance

The Supreme Court summarised its reasons for finding the arrangement was a tax avoidance arrangement as follows:

1 Section BG 1(1) applies to tax arrangements (such as those associated with the note) which, but for its invocation, would have been effective in producing the desired tax advantage.

2 Such application is justified if the tax advantage results from the use of a tax provision outside the parliamentary contemplation of that provision's purpose.

3 Use of a tax provision intended to provide relief in relation to a particular economic burden (such as a cost, a loss or a reduction in income), where such a burden has not, in economic substance, been suffered, will usually lie outside of the relevant parliamentary contemplation. This is particularly so where such use is contrived and artificial.

4 In this instance the tax provisions relied on by [Frucor] provide relief in relation to "interest incurred". In economic substance, however, the payments in respect of which [Frucor] sought the disallowed deductions were repayments of principal. The arrangements on which [Frucor] relied to categorise these principal repayments as interest were contrived and artificial. Deductibility for such repayments is not within the purpose of allowing deductibility for "interest incurred". Accordingly, [Frucor's] use of the deductibility provisions lay outside of the relevant parliamentary contemplation. This means that s BG 1(1) applies to void the arrangements.

Section GB 1

The Supreme Court found that because the purpose and effect of the tax avoidance arrangements were to provide deductibility for what in economic substance were repayments of principal, the Commissioner had correctly applied s GB 1(1) to adjust the taxable income of Frucor to disallow the deductions illegitimately claimed.

Shortfall Penalties

The Supreme Court noted, that in this case at least, the application of the "about as likely as not to be correct" standard must be taken against the background of the facts as the Court finds them to be.

Based on the facts as the Supreme Court found them to be, the tax positions adopted by Frucor did not meet that standard and were thus unacceptable. Further, Frucor acted with the dominant purpose of obtaining tax advantages with the result that the tax positions were abusive.

The Supreme Court found approaches taken to determining whether shortfall penalties should apply by the High Court and Court of Appeal were erroneous. The High Court erred because it determined the shortfall penalty question based on the facts as it found them to be, but the Supreme Court considered those factual findings to be wrong. The Court of Appeal did not seek to apply the "as likely as not to be correct standard" to the facts as it found them to be. Instead, it allowed its conclusion to be controlled by the result arrived at by the High Court Judge, despite not accepting his factual findings.

CSUM 22/06: Court of Appeal confirms High Court order that backdating of child support liability was invalid

Decision date: 30 November 2022

Case

Commissioner of Inland Revenue v Lindsay [2022] NZCA 585

Legislative References

Child Support Act 1991 (as it applied in October 2003), ss 4, 14, 17, 18, 19

Judicial Review Procedure Act 2016, s 16

Legal terms

Judicial review; Child support; Proof of paternity; Backdated child support liability; Court's discretion in granting judicial review; Increased costs.

Summary

This was an appeal by the Commissioner of Inland Revenue (the Commissioner) of the High Court decision which upheld Mr Lindsay's judicial review, making a declaration that the child support assessment dated 23 November 2017 was invalid to the extent that it imposed backdated liability to 2003. The Commissioner also appealed the High Court's 10% uplift award of costs.

A cross appeal of the High Court decision to only award Mr Lindsay a 10% uplift in costs was undertaken by Mr Lindsay.

The Court of Appeal dismissed the Commissioner's substantive appeal and upheld the High Court's declaration that the child support assessment which backdated Mr Lindsay's liability to 2003 was invalid. However, the Court of Appeal allowed the Commissioner's costs appeal and set aside the 10% uplift awarded by the High Court.

Mr Lindsay's cross appeal asking for an increase in uplift from 10% was dismissed.

Impact

The outcome of this case turns on its facts, however, the decision is significant being an appeal of a New Zealand Court's first consideration of the interpretation of s 19 of the Child Support Act 1991 (**the Act**). However, the case will have limited precedential effect as s 19 of the Act has been further amended by the Child Support Amendment Act 2021. This amendment provides that child support only be backdated on receipt of a declaration of parentage if the custodial parent applied for the order within limited timeframes.

Facts

Mr Lindsay and Ms Jones began a sexual relationship in approximately 2000 which continued until the end of 2002.

Ms Jones advised Mr Lindsay in March 2003 that she was pregnant with his child, and she gave birth to their son in September 2003. She applied for child support in October 2003, but it was declined on the basis the application did not provide proof of paternity or proof of birth.

In 2016, Mr Lindsay was served with paternity proceedings by Ms Jones. He defended the proceedings on the basis that he could not be sure that he was the father but agreed to do DNA testing. This testing established he was the father, and a paternity order was made by consent by the Family Court on 26 October 2017. Ms Jones applied for child support at this time.

On 27 November 2017 the Commissioner determined that Mr Lindsay was obliged to provide child support and his liability was backdated to 2003, the time when Ms Jones first made an application for child support. The backdated amount owing by Mr Lindsay was around $90,000.

Issues

The issues for consideration by the Court of Appeal were:

- Whether the High Court erred in making a declaration that the child support assessment dated 23 November 2017 made by the Commissioner was invalid to the extent it imposed backdated liability to 2003. Specifically –
  - i) Was the Judge correct to find s 19 only applied to a live child support applications and that the 2003 application was no longer live as at 2017.
  - ii) Was the Judge correct to find s 19 did not apply because 'unable to accept' in s 19 differs in meaning to 'refuse to accept' used elsewhere in part 1 of the Act.
- Should the Judge have exercised his discretion not to grant relief on the basis Mr Lindsay had not properly exercised his right of objection under the Act?
- Was the costs awarded appropriate in all the circumstances?

Whether the High Court erred in making the declaration the child support assessment was invalid

Was the 2003 application live?

The Court of Appeal considered the conclusion that the 2003 application was no longer live as of 2017 was well supported by the evidence. Firstly, it considered the 2003 application was largely pro forma in nature, likely prompted by the requirement in s 9 of the Act which required the recipient of a social welfare benefit to apply for a child support formula assessment. There was no incentive for Ms Jones to pursue the application as any child support payments would be retained by the state.

Secondly, from 2006, any child support payments would have gone directly to Ms Jones as she was no longer in receipt of a benefit. She was aware that if the non-custodial parent did not pay child support, then she would not be paid child support. Ms Jones did not take any further steps to obtain child support for a further 10 years.

Finally, when Ms Jones contacted the Commissioner in 2016, neither she nor the Inland Revenue officer she spoke to considered the 2003 application was still live. Ms Jones was advised to file another application which she did in 2017.

Does section 19 only apply to live applications?

The Court of Appeal's view was that when s 19 is considered purposively and in light of the statutory context it must be limited to applications that are live.

Section 19 provides an exception to the default position in s 17(2) which provides for liability for child support to commence when an application is 'properly made' ie: when all relevant information has been provided. The Court of Appeal acknowledged that the exception in s 19 allowing child support to be backdated to when the application was made following the provision of all relevant information reflects a recognition that it can be difficult to obtain proof of parentage and without the exception it could incentivise liable parents to delay or frustrate attempts to establish proof of parentage. However, the facts did not fall within the scope of this s 19 purpose as the delays were not due to Mr Lindsay but due to Ms Jones who elected not to take steps to prove paternity and as such the 2003 application became defunct.

The scheme of the Act does not envisage custodial parents seeking backdated payment of child support many years after the costs are incurred. The objects of the Act include ensuring the level of financial support is determined according to the parents' financial capacity. This capacity is assessed on an annual basis based on the liable parents' income of the previous year. The scheme of the Act enables carers to receive ongoing financial support when needed and allows liable parents to manage their affairs in real time.

The Court of Appeal agreed with the High Court that Mr Lindsay's right to procedural fairness would be cut across if liability was backdated 14 years in reliance on the 2003 application, which Mr Lindsay was not notified of and which the Court considered abandoned by 2006 (at the latest). In addition, the penalties arising as a consequence of backdating liability for many years were severe; the Court of Appeal considered this outcome to be draconian and unjust which further supported a view that Parliament could not have intended the literal application of s 19 in this case.

Was the High Court correct to find the term 'unable to accept' in s 19 differed to 'refuse to accept'?

While it was not strictly necessary to consider this issue due to the finding s 19 only applied to live applications, the Court of Appeal made several observations including:

- The statutory framework does not support the view that 'unable to accept' creates a third category of applications that are neither accepted or refused but 'put on hold'.
- The statutory scheme is binary and envisages two outcomes – acceptance or refusal.
- The scheme of the Act does not require the Commissioner to have an intermediate 'unable to accept' option to put an application on hold pending further information – this is provided for in the binary framework.

In addition, the Court of Appeal found the High Court erred in finding the Commissioner had refused the 2003 application as the evidence did not support the conclusion that Ms Jones had advised in that application that she did not intend to pursue paternity proceedings. She was simply confirming paternity action had not yet been taken at the time of making the 2003 application.

Should the Hight Court have declined to grant relief?

The Court of Appeal agreed with the High Court that Mr Lindsay's judicial review application was not an abuse of process. Therefore, the decision to reject the Commissioner' submission that the High Court should have declined to grant relief was correct. The prospect of Mr Lindsay obtaining legal advice and lodging a properly informed objection following the notices of assessment in November 2017 within the statutory timeframe was negligible. By the end of December 2017, he had lost the ability to object to the assessments as of right. At the time his objection was rejected for lateness Mr Lindsay understood judicial review was the only option available to him and the issues were suitable for that procedure.

Was the costs award appropriate?

The Court of Appeal agreed with the High Court that the high threshold required for indemnity costs was not met in this case. There was nothing to suggest the Commissioner had acted otherwise than in good faith in exercising his statutory role.

However, the Court of Appeal disagreed with the High Court increasing costs pursuant to the High Court Rules. There was nothing here to suggest Mr Lindsay was motivated to bring proceedings in the public interest. He was solely concerned (appropriately) with challenging his own child support liability. They accepted the Commissioner did not run the case as a matter of principle but that he defended it on the basis he had correctly applied the law and the assessments were valid.